The Structure of Stockholder Litigation: When Do the Merits Matter?

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This Article investigates a question that has preoccupied corporate law scholarship for nearly seventy-five years: Do the merits matter in stockholder litigation? We exploit variation in the remedies available to stockholders at merger to show that classic stockholder litigation seems driven largely by factors unrelated to legal merit. Merger litigation offers an especially apt setting to study this question because of two unique features. First, in merger litigation, the merits of the legal claims are uniquely easy to perceive. Prior work has relied on proxies for litigation merit—the presence of an accounting restatement, a parallel SEC inquiry, and so forth. A merger, however, is an end-period transaction, and the only issue of genuine consequence to a typical stockholder will be the adequacy of the merger consideration. The second unique advantage of studying mergers is that stockholders have two distinct types of legal remedies available to them—filing a class action alleging fiduciary breach or seeking stockholder appraisal. The fiduciary class action shares the same basic structure as other forms of stockholder litigation like federal securities suits and derivative claims: a class comprised of all shareholders, lead plaintiffs with small holdings, and plaintiffs' attorneys with control of the claims. Appraisal litigation, by contrast, has none of these features. If the fiduciary class actions differ from appraisal in the incidence and intensity of litigation, we can thus conclude that the difference is attributable to the difference in structure.

We analyzed over 1,000 mergers from 2004 through 2013, investigating what factors are associated with fiduciary class actions and with appraisal filings. Fiduciary duty class actions challenging mergers are strongly associated with deal size, a variable that has far greater explanatory power than the merger premium. Our findings suggest that the merits count for little in the decision to bring a fiduciary suit and that such suits are brought for their nuisance value. By contrast, appraisal claims appear strongly related to legal merit. We argue that this difference demonstrates that litigation structure has a marked effect on the merits of claims. We also sketch out some preliminary reforms designed

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to restructure conventional stockholder litigation in ways that will reduce meritless claims and improve the incentive to prosecute strong claims.

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I. INTRODUCTION

For decades, scholars and policymakers have debated whether the legal merits of claims matter in stockholder litigation. The answer matters because stockholder litigation is the chief enforcement mechanism for the substantive rules of corporate and securities law.

Early salvoes in this debate suggested that the merits matter surprisingly little in determining whether a claim will be brought and how it will be resolved.[1] Subsequent studies have led to more equivocal results, suggesting that at least in some situations there is a relationship between the merits and outcomes.[2] These studies of the merits of shareholder litigation, however, all suffer from a common weakness: the difficulty of assessing the "merits" of complex claims in a world where stockholder suits almost never proceed to actual trial.[3] Investigators have been forced to use highly imperfect proxies for merit, given the impossibility of directly assessing the merits of claims alleging fraud or breach of fiduciary duty and involving fact-sensitive questions like, for example, the defendants' state of mind. As a result, conclusive results have thus far been elusive.

We surmount this problem of assessing the merits of shareholder litigation by examining shareholder class actions that challenge proposed takeovers, the dominant form of shareholder suit today.[4] Merger claims offer two major advantages in asking whether the merits matter. First, we can directly observe the paramount merits issue of claims attacking proposed takeovers instead of relying on some proxy for merit.[5] Takeover transactions are end-period transactions, and the shareholders of the target firm typically receive the merger consideration and thereafter have no ongoing relationship with the enterprise. While shareholder actions challenging a proposed transaction are often couched

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[1] *See, e.g.*, Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 500 (1991); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation*, 7 J.L. ECON. & ORG. 55, 61 (1991).

[2] *See, e.g.*, Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465, 1486–99 (2004); James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 502 (1997). For an excellent summary of the large body of empirical work on this question, see James D. Cox & Randall S. Thomas, *Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 COLUM. L. REV. 1587, 1592–93 (2006); *see also* Quinn Curtis & John Morley, *An Empirical Study of Mutual Fund Excessive Fee Litigation: Do the Merits Matter?*, 30 J.L. ECON. & ORG. 275, 280 (2014) ("[T]here appears to be a growing consensus that the relationship [between merits and outcomes in class actions and derivative litigation] is reasonably strong.").

[3] To get some indication of the infrequency with which shareholder litigation results in trial, consider that of the approximately 4000 federal securities class actions filed in the past twenty years, only about twenty (0.5%) have gone to trial. *See* RENZO COMOLLI ET AL., NERA ECON. CONSULTING, RECENT TRENDS IN SECURITIES CLASS ACTION LITIGATION: 2012 FULL-YEAR REVIEW 38–39 (2013), *available at* http://www.nera.com/content/dam/nera/publications/archive2/PUB_Year_End_Trends_2012_1113.pdf.

[4] A series of papers by Matthew Cain and Steven Davidoff has documented the increasing frequency of merger litigation. *See* Matthew D. Cain & Steven M. Davidoff, Takeover Litigation in 2012, at 1–2 (Feb. 1, 2013) (unpublished manuscript), *available at* http://ssrn.com/abstract=2216727 (finding that almost 92% of all transactions with a value greater than $100 million experienced litigation in 2012); *see also* Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 135 (2004) (reporting that "acquisition-oriented suits are now the dominant form of corporate litigation and outnumber derivative suits by a wide margin").

[5] *See infra* Part II.

in terms of violations of fiduciary duty, the only issue of genuine consequence to a typical shareholder will be the adequacy of the merger consideration. We can thus examine directly the role of this important metric of merit in takeover litigation.

The second major advantage of studying mergers is the availability of stockholder appraisal, a parallel remedy for challenging the merger consideration against which fiduciary class actions can be contrasted.[6] The structure of an appraisal claim—the composition of the plaintiff class, the role of the attorney, and the fee-shifting rules—is radically different from that of fiduciary class actions, and we exploit this difference to test whether the structure of the litigation affects the merits of the claims.

In a fiduciary class action, the claims by default proceed on behalf of the entire shareholder class. All of the major species of shareholder litigation—not just fiduciary class actions but also derivative suits and federal securities claims—are brought in a representative capacity, initiated and managed by professional plaintiffs' attorneys.[7] The actual named plaintiff is typically an unimportant player in the litigation, exercising little oversight over the prosecution or settlement of the claims. Many scholars have identified this relationship between the shareholders, on whose behalf the claims are brought, and the plaintiffs' attorneys who control those claims as the root problem in shareholder litigation.[8] The risk is that plaintiffs' attorneys may not be perfectly faithful agents for shareholders, and they may bring claims that are not in the best interests of shareholders. It can also lead plaintiffs' attorneys to forego aggressive litigation of meritorious actions in favor of a quick settlement that provides generous attorneys' fees.[9] Stockholders themselves face powerful

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[6] *See infra* Part III.B. The appraisal remedy gives a dissenting stockholder the option of refusing the consideration offered in a merger and instead receiving a cash payment for their shares at a judicially-determined fair value. *See* DEL. CODE ANN. tit. 8, § 262 (2013). Other states provide an appraisal remedy for a wider array of corporate actions, but Delaware—which will be the focus of this Article—restricts appraisal actions to mergers. *See, e.g.*, 3 MODEL BUS. CORP. ACT ANN. § 13.02 (2013).

[7] *See* Stephen J. Choi, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?*, 23 J.L. ECON. & ORG. 598, 598 (2007).

[8] *See infra* Part II.

[9] Delaware courts, for example, have complained about the profusion of "disclosure only" settlements in merger cases, in which the defendants agree to pay significant fees to the plaintiffs' attorneys, while simply agreeing to provide additional disclosure to shareholders. *See, e.g.*, Transcript of Courtroom Status Conference at 19, Scully v. Nighthawk Radiology Holdings, Inc., No. 5890-VCL (Del. Ch. Dec. 17, 2010) (referring to disclosure only settlements as "cheap settlement"). A working paper by Matthew D. Cain and Steven M. Davidoff examines mergers in 2010 with a deal size greater than $100 million and finds that approximately 77% of claims that were not dismissed outright resulted in so-called "disclosure only" settlements and that the mean fees provided to plaintiffs' attorneys in such settlement was approximately $749,000. Matthew D. Cain & Steven M. Davidoff, A Great Game: The Dynamics of State Competition and Litigation 37 (Jan. 2013) (unpublished manuscript), *available at* http://ssrn.com/abstract=1984758. Another 14% resulted in largely

collective action problems in monitoring such settlements. The enduring question is whether this relationship attenuates the connection between the merits and litigation.[10]

The structure of appraisal claims offers a stark contrast to other forms of stockholder litigation. Each stockholder must affirmatively opt-in to the appraisal claim by meeting certain procedural requirements. As a result, an attorney representing a small stockholder cannot bring an appraisal claim in the hopes of gaining representative status for a larger class and, accordingly, a larger potential recovery. The shareholders must hire the attorneys, not the other way around. In addition, Delaware's appraisal statute makes no provision for allocating the plaintiff's attorney fees to the defendant.[11] The result of this unusual feature is that, absent extraordinary circumstances, each side must bear its own attorneys' fees.[12] Consequently, if plaintiffs' attorneys are to receive payment, it can only come from the plaintiffs, either directly or out of a genuine monetary recovery. This should serve to align the incentives of the attorney with those of the plaintiff shareholders.

If the pathologies associated with standard stockholder litigation are caused—or at least exacerbated—by the ability of plaintiffs' attorneys to secure large fees even in the absence of genuinely valuable recovery to the shareholder

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cosmetic changes to the merger agreement, with no increase in consideration. *Id.* Mean fees provided to plaintiffs' attorneys for such settlements were approximately $1,761,000. *Id.*

[10] For influential discussions of the problematic incentives involved, see Lucian Arye Bebchuk, *Suing Solely to Extract a Settlement Offer*, 17 J. LEGAL STUD. 437, 437 (1988); John C. Coffee, Jr., *Rescuing the Private Attorney General: Why the Model of Lawyer as Bounty Hunter is Not Working*, 42 MD. L. REV. 215, 218 (1983); Jill E. Fisch, *Class Action Reform: Lessons from Securities Litigation*, 39 ARIZ. L. REV. 533, 533 (1997); D. Rosenberg & S. Shavell, *A Model in Which Suits are Brought for Their Nuisance Value*, 5 INT'L REV. L. & ECON. 3, 3 (1985). This problem persists in spite of various federal and state reforms have attempted to address this problem by prioritizing certain shareholders and attorneys in disputes for lead plaintiff. Most prominently, in 1995, Congress overrode a presidential veto to pass the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.). Among other things, the Private Securities Litigation Reform Act (PSLRA) improved the ability of large shareholders to be appointed lead plaintiff in shareholder actions. *See* 15 U.S.C. § 78u-4(a)(2)(B) (2012). Empirical investigations of these reforms report mixed results. *See infra* Part II.A. Delaware's lead plaintiff rules are attentive to the named plaintiff's holdings but also to other factors. These reforms fail to change the basic nature of the relationship between the attorney and the client in shareholder litigation.

[11] *See* Mary Siegel, *An Appraisal of the Model Business Corporation Act's Appraisal Rights Provisions*, 74 LAW & CONTEMP. PROBS. 231, 241 (2011). Siegel notes that the Delaware "statute's only reference to expenses allows the court discretion to allocate a shareholder's expenses among all shares entitled to appraisal." *Id.*

[12] The Delaware courts have crafted a "narrow" equitable exception to the default rule that both parties bear their own legal expenses where one side acts in bad faith, but this exception is rarely applied. *See id.* As is discussed *infra* note 191, virtually every appraisal action settlement approved by the Delaware courts provided that each party would bear its own costs.

plaintiffs, we would expect to see these pathologies significantly reduced in the appraisal context. In addition to a much-reduced agency problem, an appraisal proceeding presents the shareholder with a genuine risk of financial loss that is absent from other shareholder litigation. The shareholder must forego the merger consideration in order to pursue appraisal, and the court in an appraisal proceeding can ultimately determine fair value to be less than what the shareholder would have received.[13] Unlike plaintiffs in fiduciary class actions, appraisal petitioners have real skin in the game, and we hypothesize that this too might focus their attention on legal merit. Taken together, these features mean that Delaware appraisal actions present a unique type of shareholder claim where the merits ought to matter a great deal.[14] Because a crucial merits issue is the same in takeover litigation and in appraisal—the adequacy of the merger consideration—we can use appraisal as a benchmark against which to measure the merits of takeover litigation.

Until now, such a comparison has not been possible, due to a lack of data on the characteristics of appraisal litigation. The prior lack of interest in appraisal stems, no doubt, from the longstanding conventional wisdom that the shareholder appraisal action is largely a dead letter, of little or no use to shareholders,[15] and of no practical significance in modern mergers.[16] As one

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[13] *See infra* Part III.

[14] *See infra* Part V.

[15] *E.g.*, Bradley R. Aronstam et al., *Delaware's Going-Private Dilemma: Fostering Protections for Minority Shareholders in the Wake of* Siliconix *and* Unocal Exploration, 58 BUS. LAW. 519, 546 (2003) ("[I]n practice, the appraisal remedy is replete with shortcomings and therefore fails to protect adequately minority shareholders from majoritarian abuse."); John C. Coffee, Jr., *Transfers of Control and the Quest for Efficiency: Can Delaware Law Encourage Efficient Transactions While Chilling Inefficient Ones?*, 21 DEL. J. CORP. L. 359, 412 (1996) ("Standing alone, the appraisal remedy cannot begin to assure the receipt of proportionate value."); Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 1005 (2006) ("The shortcomings of the appraisal remedy are widely known. Commentators have long recognized that appraisal is a remedy that few shareholders will seek under any circumstance."); Joel Seligman, *Reappraising the Appraisal Remedy*, 52 GEO. WASH. L. REV. 829, 830 (1984) (arguing that appraisal suffers from "substantial defects in the ability of state corporate law to ensure dissenting shareholders the fair value of their shares"); Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L.J. 2, 31 (2005) ("[I]t is well accepted among academic commentators and practitioners that appraisal is a weak remedy compared to entire fairness review."); *see also* JAMES D. COX ET AL., CORPORATIONS 601 (1997) ("[T]he risk of considerable expense as well as the procedural difficulties in pursuing the [appraisal] remedy further decrease its effectiveness in protecting minority shareholders."); 2 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS ch. 4, intro. note (1994) ("The practical utility of the appraisal remedy as a protection for minority shareholders has been the subject of much debate, and few legal commentators have been confident that the remedy works sufficiently well to play a major role in corporate governance.").

[16] *See* Paul G. Mahoney & Mark Weinstein, *The Appraisal Remedy and Merger Premiums*, 1 AM. L. & ECON. REV. 239, 242 (1999).

Delaware opinion noted, appraisal is "chock-full of disadvantages for shareholders."[17] In a companion paper, we present a full empirical picture of contemporary appraisal activity and argue that prior commentators have underestimated the social utility of appraisal.[18] Here, we use the differing structures of appraisal and fiduciary class actions as a natural experiment to investigate the role of legal merit in conventional shareholder litigation.

We identified all appraisal-eligible merger transactions involving a Delaware-incorporated target for the ten-year period from the beginning of 2004 through the end of 2013. We limit our study to appraisal-eligible transactions so we can compare the selection of mergers for legal challenge via fiduciary duty class action against the selection for appraisal petition.[19] This ensures as close to an apples-to-apples comparison as possible, where differences in litigation patterns cannot be explained by differences in the underlying universe of transactions. We examined each transaction to determine whether a fiduciary class action was filed challenging the merger, whether an appraisal petition was filed, or whether both types of claims were brought.

To determine whether the merits matter, we compare the characteristics of mergers that resulted in fiduciary duty class actions to the larger universe of mergers. The size of the merger premium should be correlated to the magnitude of the potential damages and also to the probability of a breach of fiduciary duty. If the merits matter, we would expect to observe an inverse relationship between the size of the merger premium and the likelihood of a fiduciary class action challenging the merger. That is, shareholders should be more willing to challenge the merger when they are set to receive a small premium over the market value of their shares, and less likely to do so when they would receive a large premium.

We also examine the relationship between the overall size of the deal and the likelihood of a fiduciary duty class action. While the size of the deal is generally correlated to the potential damages available, the deal size should be—at most—approximately as relevant to the merits as the size of the merger premium. If, however, the incidence of class action litigation is driven by plaintiffs' attorneys searching for deep pockets, we would expect a far stronger positive relationship between deal size and the likelihood of a claim.[20]

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[17] Turner v. Bernstein, 776 A.2d 530, 547 (Del. Ch. 2000).

[18] *See* Charles R. Korsmo & Minor Myers, *Appraisal Arbitrage and the Future of Public Company M&A*, 92 WASH. U. L. REV. (forthcoming 2015), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2424935.

[19] As discussed more fully *infra* Part III, the appraisal remedy is only available for a subset of all merger transactions.

[20] Davidoff and Cain, for example, have found that in recent years a large percentage of all mergers with a deal size greater than $100 million have resulted in some form of shareholder litigation. Cain & Davidoff, *supra* note 4, at 2 (finding that 92% of all transactions with a value greater than $100 million experienced litigation in 2012). Similarly, Curtis and Morley find that mutual fund family size is the single greatest predictor of excessive fee litigation—greater even than the size of the fees being challenged as excessive. *See* Curtis & Morley, *supra* note 2, at 275.

Consistent with this expectation, we find that fiduciary duty class actions challenging mergers are strongly associated with deal size and that deal size has far greater explanatory power than the merger premium. Our findings suggest that the merits count for little in the decision to bring suit and that such actions are frequently brought primarily for their nuisance value.[21]

To test this conclusion, we also examine the incidence of appraisal actions. We have assembled a hand-collected data set of every appraisal action filed in Delaware for the ten-year study period.[22] We find that appraisal activity—unlike fiduciary litigation—is not correlated with deal size at all. This finding supports the conclusion that the usual correlation between deal size and shareholder litigation is driven by agency problems and asymmetric litigation risks that are largely absent in the appraisal context. We also examine the merger premium for deals that attracted an appraisal petition versus those that did not.[23] Again, in contrast to the results for fiduciary duty class actions, we find that there is a strong correlation between the merger premium and the likelihood of an appraisal claim. Mergers with smaller premia are more likely to attract appraisal actions, precisely as we would expect if the decision to seek appraisal is based on the merits of the underlying claim.

In sum, our findings show that the merits matter in the incidence and intensity of appraisal actions, and we find no evidence that such actions are being driven by an attempt to capture nuisance value. This stands in stark contrast to the fiduciary class action litigation, where deal size is the strongest predictor of litigation, with far greater influence than the size of the merger premium. These results represent the most conclusive evidence yet that the merits matter little in at least one important class of stockholder litigation. The contrasting example of appraisal litigation involving the same universe of transactions makes the conclusion all the more compelling.

We offer some possible avenues for improving stockholder suits, though a detailed program of reform is beyond the scope of this Article. Our results support the idea that the well-known pathologies of stockholder litigation are, in fact, driven by its structural features.[24] Thus, the chief reform objective should be to alter the structure of shareholder litigation—in particular, to ensure that the plaintiff in control of filing and releasing the claims has a meaningful economic stake in those claims. One of our preliminary ideas about reform is altering the criteria for selecting the lead plaintiff to favor stock acquired after the announcement of a merger or—more drastically—switching to an opt-in class. Such reforms would lead to higher-quality claims with stronger deterrence value.

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[21] *See infra* Part IV.

[22] We located cases by searching for the Delaware Chancery Court dockets for the term "appraisal," both on Westlaw and on Bloomberg, and evaluated the results for relevance.

[23] *See infra* Part V.C.

[24] *See infra* Part IV.D.

The Article proceeds as follows. Part II introduces the debate over the merits of shareholder litigation and demonstrates the problem of finding a suitable proxy for merit. Part III describes the fiduciary class actions and appraisal petitions, explaining how they allow us to conduct a more direct investigation of the merits. Part IV presents the results of the empirical investigation of the merits of fiduciary class action claims, revealing that it is driven chiefly by factors unrelated to merit. In Part V, we present the companion analysis of appraisal litigation, where we find that litigation activity is strongly correlated with merit. Part VI explores the implications of our results and offers some tentative recommendations for reform. A brief conclusion follows.

II. THE DEBATE OVER THE MERITS OF SHAREHOLDER SUITS

It has long been recognized that the structure of shareholder litigation lends itself to abuse. In particular, plaintiffs' attorneys may file lawsuits and settle them with little regard for the legal merits of the underlying claims. Legal commentators have dedicated enormous attention to this contentious issue, analyzing the incentives that bear on the various parties involved in shareholder suits and assessing the merits of the claims that are ultimately brought. The debate has even, on occasion, spilled over into the larger political arena, as it did during the disputes surrounding the Private Securities Litigation Reform Act (PSLRA), which was ultimately passed when Congress overrode President Clinton's veto in 1995.[25] Definitive conclusions, however, have been surprisingly elusive, in part due to the extreme difficulty of determining—or often even defining—the merits of a shareholder suit. That task is especially difficult because the vast majority of suits settle prior to any adjudication on the merits. This section introduces the potentially troubling features of shareholder litigation, the debate over the merits of the resulting claims, and the difficulty of making an uncontroversial assessment of the merits of a shareholder suit.

A. *Collective Action and Agency Problems in Shareholder Litigation*

Shareholder litigation has traditionally been thought to play an important role both in the enforcement of the federal securities laws and in corporate governance more broadly. Private securities fraud actions hold out the possibility of a significant private supplement to public enforcement of the securities laws by the SEC and other regulatory agencies.[26] Similarly, fiduciary

[25] *See generally* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 107 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

[26] *See*, *e.g.*, Choi, *supra* note 7, at 598 ("Securities fraud class actions act as a complement to public enforcement actions on the part of the Securities and Exchange Commission (SEC)."); Cox, *supra* note 2, at 497 ("The [securities] class action thereby has an important deterrent feature which give[s] it a quasi-public character; it can thus be seen as an extension of the state's enforcement arm and an expression of society's will.").

duty actions may serve as a corporate governance mechanism of last resort where traditional mechanisms—such as oversight by boards of directors,[27] executive compensation arrangements,[28] or the market for corporate control[29]—have failed to deter wrongdoing by officers and directors.[30]

If shareholder suits are to fulfill their promise, however, it is generally thought that some method of representative litigation is necessary. Individual stockholders often have little incentive to bring suits. Their holdings are generally too small to make their share of the potential recovery attractive enough to undertake the costs of pressing stockholder claims. In the absence of an aggregation mechanism, the cost of litigation is likely to exceed the value of any but the largest individual shareholders' prospects of gain from a suit. This would prevent a suit from being brought even where stockholders as a whole would likely stand to gain far more from a suit than the costs of litigation.[31] By allowing a plaintiff to proceed on behalf of a class of similarly situated stockholders, or on behalf of the corporation as a whole via a derivative suit, the potential recovery is equal to the entire loss suffered by stockholders, encouraging plaintiffs to file socially desirable suits.[32]

The great virtue of representative litigation is that it makes it practicable for private attorneys to police managerial misbehavior. Representative litigation,

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[27] *See, e.g.*, Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1198–1200 (1984).

[28] *See, e.g.*, Clifford W. Smith, Jr. & Ross L. Watts, *Incentive and Tax Effects of Executive Compensation Plans*, 7 AUSTL. J. MGMT. 139, 140 (1982).

[29] *See, e.g.*, Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461, 461–65 (1986).

[30] *See* Coffee, Jr., *supra* note 10, at 216 ("[T]he private attorney general is someone who sues to vindicate the public interest by representing collectively those who individually could not afford the costs of litigation; and, as every law student knows, our society places extensive reliance upon such private attorneys general to enforce the federal antitrust and securities laws, to challenge corporate self-dealing in derivative actions, and to protect a host of other statutory policies." (internal quotation marks omitted)); Romano, *supra* note 1, at 55.

[31] *See* Choi, *supra* note 2, at 1466 ("Shareholders of large publicly held corporations face a well-known collective action problem . . . . Corporations owe their shareholders specific duties and rights. However, due to the collective action problem, no single shareholder may seek to litigate these rights."); Romano, *supra* note 1, at 55 ("The efficacy of shareholder litigation as a governance mechanism is hampered by collective action problems because the cost of bringing a lawsuit, while less than the shareholders' aggregate gain, is typically greater than a shareholder-plaintiff's pro rata benefit.").

[32] *See* Choi, *supra* note 7, at 598 ("Securities fraud class actions provide dispersed shareholders of a corporation with a mechanism to aggregate shareholder interests in pursuing litigation against companies and related parties who engage in fraud. Without class actions, dispersed shareholders may not find litigation individually cost-effective."); Choi, *supra* note 2, at 1466 ("Class actions, at least in theory, work to ameliorate the collective action problem confronting shareholders."); Cox, *supra* note 2, at 497 ("Where the single claimant could not proceed individually because her expenses would dwarf the expected recover[y], the class action can be brought on behalf of all who are similarly situated.").

however—whether via a class action or derivative mechanism—generates a new set of potential problems. Even without representative litigation, a danger always exists that legal claims may be brought not in the realistic expectation of a judgment on the merits but rather to capitalize on the nuisance value of the claim.[33] Even a frivolous claim costs time and money to defend, and thus defendants may find it in their interests to settle claims even when they believe them to be without merit.[34] Nuisance suits may be profitable whenever

[33] It is rarely possible to define when a suit is "non-frivolous" or "socially desirable" in a non-controversial fashion. *See* Robert G. Bone, *Modeling Frivolous Suits*, 145 U. PA. L. REV. 519, 529–33 (1997) (considering and rejecting a number of common definitions of "frivolous litigation"). For present purposes, however, we can speak somewhat loosely of a suit being non-frivolous where the expected benefits to the plaintiffs from a trial exceed the expected costs of litigation. Arguably, though, even lawsuits not meeting this definition can be socially desirable if—in addition to recovery to the particular plaintiffs—they provide some public benefit, such as general deterrence of wrongdoing or the development and clarification of legal rules that then serve as public goods. *See* Coffee, Jr., *supra* note 10, at 218 ("The conventional theory of the private attorney general stresses that the role of private litigation is not simply to secure compensation for victims, but is at least equally to generate deterrence, principally by multiplying the total resources committed to the detection and prosecution of the prohibited behavior."); Romano, *supra* note 1, at 85. If, on the other hand, lawsuits merely consume resources and redistribute wealth without producing desirable incentive effects, they may be socially undesirable even when the benefits to plaintiffs exceed the costs. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 639–40 (1985); Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 646–48 (1996) (arguing that a goal of full compensation would lead to socially undesirable results).

[34] *See, e.g.*, Alexander, *supra* note 1, at 505 (describing the ability of "unscrupulous plaintiffs to extort nuisance-value settlements for frivolous claims"); Choi, *supra* note 7, at 598–99 ("Many argue that at least some class actions are initiated in expectation of a nuisance settlement, paid by the defendants to avoid the distraction of litigation, high defense attorney fees, and the negative publicity surrounding a securities lawsuit." (citations omitted)); Choi, *supra* note 2, at 1469 ("Getting rid of even frivolous litigation is not cost-free. If a court is unable to verify whether litigation is meritorious at the start of the litigation, a class action suit may last a considerable amount of time. During this time, defendants will incur attorneys' fees as well as the distraction of dealing with discovery (including lengthy depositions of the top officers) and negative publicity affecting relations with both customers and suppliers. Settling even nuisance litigation allows a company to avoid such costs."); Coffee, Jr., *supra* note 10, at 271 (noting that corporate defense counsel often claims "that the corporation is better served even in a frivolous case by settling quickly rather than by expending time and effort litigating to a successful conclusion"); *see also* Robert D. Cooter and Daniel L. Rubinfeld, *Economic Analysis of Legal Disputes and Their Resolution*, 27 J. ECON. LIT. 1067, 1084 (1989). Coffee cites game theory literature for the proposition that even where it may be in the corporation's interest to settle even frivolous claims from an ex post perspective once a claim is filed, from an ex ante perspective a defendant may be better off in the long run developing a reputation for playing hardball in order to deter frivolous claims from being brought in the first place. Coffee, Jr., *supra* note 10, at 271–72; *accord* THOMAS C. SCHELLING, THE STRATEGY OF CONFLICT 37–42, 137–39 (1960). Because shareholder litigation tends to be a relatively rare event in an individual corporation's life, however, we are dubious that the long-term gains from such a strategy

defendants are risk-averse or face asymmetric litigation costs.[35] As Janet Cooper Alexander summarized the economic arguments, "high litigation costs and uncertainty about trial outcomes can lead to the settlement of frivolous suits."[36] To the extent that aggregate litigation increases asymmetries between plaintiff and defendant litigation costs and creates the possibility—even if it is only a low probability—of catastrophic damages, frivolous litigation will be more likely when aggregate litigation is available. The risk of frivolous shareholder litigation is made even more acute by the ubiquity of liability insurance for directors and officers that will pay some or all of the costs of a settlement, but will not pay if the defendants are found culpable at trial.[37]

Even more troubling, at the same time aggregate litigation serves as a potential mechanism for addressing the agency problem between shareholders and corporate managers, it generates a new agency problem, this time between the shareholders and their plaintiffs' attorneys.[38] The plaintiffs' attorneys—who generally receive a share of any settlement as a contingency fee—have a financial stake in the claims that virtually always far outweighs that of any individual shareholder in a publicly traded firm.[39] As Professor Alexander explains, "[t]he class action device makes private enforcement economically

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would clearly outweigh the benefits of simply buying off frivolous claims when they do arise. *See*, *e.g.*, Romano, *supra* note 1, at 59 (noting that "shareholder litigation is . . . an infrequent experience" in the life of most firms).

[35] *See* Bebchuk, *supra* note 10, at 448; Coffee, Jr., *supra* note 10, at 230–34; Fisch, *supra* note 10, at 554; Rosenberg & Shavell, *supra* note 10, at 9 10.

[36] Alexander, *supra* note 1, at 502 n.10.

[37] *See* Alexander, *supra* note 1, at 550 (arguing that "[t]he existence and operation of insurance and indemnification may be the most important factor in creating a system of settlements that do not reflect the merits"); Choi, *supra* note 2, at 1469 (noting that "many companies have liability insurance policies for their directors and officers, many of which will not pay if the directors or officers are found culpable at trial . . . [so r]ather than face this prospect (even if unlikely), directors and officers will often settle, relying on the . . . [D&O] liability insurers to pay most, if not all, of the settlement award"); Romano, *supra* note 1, at 57 ("[A]ll states permit corporations to purchase D&O liability insurance for their executives, and policies can cover losses that cannot be indemnified. Policies routinely exempt losses from adjudication of dishonesty, but if a claim is settled, courts prohibit insurers from seeking an adjudication of guilt and thereby avoiding the claim's payment."); *see also Securities Litigation Reform: Hearings Before the Subcomm. on Telecomm. and Fin. of the H. Comm. on Energy and Commerce*, 103d Cong. 468 n.11 (1994) (statement of Marc E. Lackritz) (claiming that 96% of securities class action settlements are within the D&O insurance coverage limits, with the insurance usually the lone source of the settlement proceeds); *see generally* TOM BAKER & SEAN J. GRIFFITH, ENSURING CORPORATE MISCONDUCT: HOW LIABILITY INSURANCE UNDERMINES SHAREHOLDER LITIGATION 128 51 (2010).

[38] *See* RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 1268 n.48 (2d ed. 1995); Thompson & Thomas, *supra* note 4, at 148–57.

[39] Suppose, for example, that a typical attorneys' fee in settlement of a shareholder claim is 25% of the recovery. At any public firm, this stake in the outcome dwarfs that of virtually any public shareholder.

feasible for small investors by allowing a large number of small individual claims to be aggregated," with the inevitable result that most of the class will "have only a nominal stake in the litigation."[40] The result is that, "[j]ust as [shareholders] lack sufficient economic interest to bring individual actions, they also are not motivated to sustain the information costs or expend the energy and attention required" to effectively monitor their attorney.[41] As a practical matter, then, it is the plaintiffs' attorneys and not the stockholders who decide when to initiate stockholder claims, how to prosecute them, and on what terms to settle them.[42]

An attorney-driven process need not necessarily be problematic if the incentives of the attorneys are closely aligned with those of the stockholders. Scholars have long argued, however, that this will often not be the case, and that in stockholders litigation "the conflict of interest that is inherent in all lawyer-client relationships becomes acute."[43] As a risk-averse economic actor, plaintiffs' attorneys may be tempted to settle even strong cases, as "a settlement offer that provided recovery of the attorney's tangible and opportunity costs could loom larger than the prospect of aggressively pursuing the action to a more lucrative prospective judgment or settlement."[44] In addition, lacking any interest in the ongoing enterprise being sued, plaintiffs' attorneys have little incentive to avoid bringing value-destroying nuisance claims, so long as the prospect of a settlement is reasonably strong.[45]

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[40] Alexander, *supra* note 1, at 535.

[41] *Id.*; *see also* John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 678–79 (1986); Cox & Thomas, *supra* note 2, at 1593 ("Class members suffered profound collective action problems that prevented close monitoring of the class action attorney."); Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 5 (1991) ("The named plaintiff does little—indeed, usually does nothing—to monitor the attorney in order to ensure that representation is competent and zealous, or to align the interests of the attorney with those of the class or corporation."); Deborah L. Rhode, *Class Conflicts in Class Actions*, 34 STAN. L. REV. 1183, 1203 (1982); Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2060 (1995) (arguing that lead plaintiffs are often recruited by the lawyers, rather than the other way around, and often are "poorly informed about the theories of their cases, are totally ignorant of the facts, or are illiterate concerning financial matters").

[42] *See* Macey & Miller, *supra* note 41, at 3 ("[P]laintiffs' class and derivative attorneys function essentially as entrepreneurs who bear a substantial amount of the litigation risk and exercise nearly plenary control over all important decisions in the lawsuit.").

[43] Alexander, *supra* note 1, at 535.

[44] Cox & Thomas, *supra* note 2, at 1593.

[45] *See* Randall S. Thomas & Robert B. Thompson, *Empirical Studies of Representative Litigation*, *in* RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW 152, 155 (Claire A. Hill & Brett H. McDonnell eds., 2012) [hereinafter Thomas & Thompson, *Empirical Studies*] ("[I]f suits were being driven too much by lawyer interests,

Finally, plaintiffs' attorneys—and the defendants sitting across the table from them—have every incentive to maximize the portion of the economic value of a settlement going to the plaintiffs' attorneys, even at the expense of the shareholders. Commentators have long noted the prevalence of settlement agreements providing little or no tangible recovery to shareholders, while providing generous attorneys' fees. In her influential study, Roberta Romano, for example, found that only about half of the shareholder suit settlements in her sample led to any monetary recovery for shareholders at all, while nearly 90% provided cash payments to the plaintiffs' attorneys.[46] In 8% of the settlements in her sample, the *only* relief was fees for the attorneys.[47] The phenomenon has grown even more prevalent in recent years. A working paper by Steven Davidoff and Matthew Cain studying shareholder challenges to large merger transactions in 2010 found that nearly 80% of the ensuing litigation resulted in so-called disclosure-only settlements, with no financial recovery to shareholders at all.[48] Despite the lack of any tangible recovery for shareholders, the mean fee provided to plaintiffs' attorneys in such settlements was more than $700,000.[49] In theory, the ability of the presiding judge to police settlements could serve as a constraint on the self-interest of the attorneys. In practice, however, a busy judge is understandably reluctant to reject a settlement that all parties before the court are pressing the court to accept.[50]

This agency problem strikes at the very heart of most stockholder litigation, and it has generated an enormous theoretical and empirical literature. Concern over plaintiffs' attorneys' incentives was the driving force behind the passage of

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representative litigation could result in the attorney initiating suits with little merit, settling strong suits for too little, and structuring the settlement so the costs are not borne by the actual wrongdoers."); Randall S. Thomas & Robert B. Thompson, *A Theory of Representative Shareholder Suits and Its Application to Multijurisdictional Litigation*, 106 NW. U. L. REV. 1753, 1762 (2012) ("Shareholder suits under both state and national law are most frequently representative, meaning that the typical case involves one named plaintiff and, importantly, one or more law firms for that prospective representative seeking to speak for a large body of shareholders. This can lead to litigation agency costs, for example, if agents bring what are perceived as strike suits or settle meritorious suits too cheaply.").

[46] *See* Romano, *supra* note 1, at 61.

[47] *Id.*

[48] *See* Cain & Davidoff, *supra* note 9, at 37–38.

[49] *See id.* at 37.

[50] As Henry Friendly remarked, "[o]nce a settlement is agreed, the attorneys for the plaintiff stockholders link arms with their former adversaries to defend [their] joint handiwork . . . ." Alleghany Corp. v. Kirby, 333 F.2d 327, 347 (2d Cir. 1964) (Friendly, J., dissenting); *see also* Cox & Thomas, *supra* note 2, at 1594 ("[T]he presiding judge, overwhelmed by a crowded docket and poorly armed against the possible self-interest of the attorneys who promoted the suit's settlement, was not capable of effectively protecting the interests of the class."). It should be noted that while Cox and Thomas described the agency problem in shareholder litigation, they exhibited some skepticism as to the conclusion that courts are ill-equipped to deal with it. *See* Cox, *supra* note 2, at 523 (arguing that even before the PSLRA, courts had the power to sanction frivolous suits and select appropriate lead plaintiffs).

the PSLRA in 1995.[51] In particular, the crucial "lead plaintiff" provision of the PSLRA—creating a strong presumption that the court should pick the shareholder with the largest financial stake to serve as lead plaintiff[52]—aims to ensure that the lead plaintiff has the incentive and ability to select and actively monitor the class attorney, reducing the agency problem.[53]

B. *Attempts to Assess the Merits of Shareholder Suits*

An enormous amount of empirical literature has attempted to determine the merits of shareholder suits. As a seminal paper phrased the question: Do the merits matter in determining when a shareholder suit will be brought and how it will be resolved? Or are disputes selected for litigation—and ultimately resolved—with little regard for the merits?[54] A subsidiary branch of this literature seeks to determine whether the PSLRA had any effect on the merits of the securities class action subset of shareholder litigation.

Two influential early studies both came to the conclusion that the merits seemed to count for little in shareholder actions. Roberta Romano examined a set of 139 shareholder suits against a randomly selected group of 535 publicly traded corporations from the late 1960s through 1987.[55] She found that a large majority of suits settled, and none resulted in judgment for damages or equitable

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[51] *See, e.g.*, Lisa L. Casey, *Reforming Securities Class Actions from the Bench: Judging Fiduciaries and Fiduciary Judging*, 2003 BYU L. REV. 1239, 1286 ("Both the statutory language and the legislative history of the PSLRA make manifest Congress's concern that securities class counsel, if left unmonitored, will behave in ways that harm both absent class members and the private enforcement system generally."); Cox & Thomas, *supra* note 2, at 1594 ("[P]erceived agency costs prompted Congress to enact the Private Securities Litigation Reform Act in 1995."); Thompson & Thomas, *supra* note 4, at 136–37 (arguing that Congress' concern with "litigation agency costs" prompted passage of the PSLRA).

[52] *See* 15 U.S.C. § 78u-4(a)(3)(B)(iii) (2012); *see also* Choi, *supra* note 2, at 1474–75 ("The PSLRA imposes a rebuttable presumption that the plaintiff, among those seeking to become the lead plaintiff, who has the largest financial interest in the relief sought by the class and is otherwise an adequate representative of the class is presumptively the lead plaintiff.").

[53] *See, e.g.*, Choi, *supra* note 2, at 1475 ("In theory, a lead plaintiff with a large stake in the litigation will have more incentive to monitor the plaintiffs' attorney's effort and also be more willing to resist excessive plaintiffs' attorney fee awards."); Cox & Thomas, *supra* note 2, at 1596 ("The theory behind [the lead plaintiff provision] was that institutions with the largest losses would have the most to gain from becoming better monitors of the conduct of the litigation."); Weiss & Beckerman, *supra* note 41, at 2111.

[54] *See* Alexander, *supra* note 1, at 498–500. Like defining "frivolous litigation," defining when a suit should be considered "merits-related" is somewhat slippery. *See, e.g.*, Bone, *supra* note 33, at 529–33. For our purposes, we may speak somewhat loosely of a suit being "merits related" when either the decision to bring a claim or the resolution of the claim (i.e., settlement amount) is determined primarily by reference to the expected damages on the merits at trial, rather than being determined primarily by the prospect of litigation costs or a risk of erroneous judgment.

[55] Romano, *supra* note 1, at 58–59.

relief for the plaintiffs.[56] As noted above, only half of settlements resulted in financial recovery for plaintiffs, while approximately 90% provided for fees to the plaintiffs' attorneys.[57] Per share recoveries were small, and non-financial "structural" settlements tended to be largely cosmetic.[58] Romano also examined price reactions to lawsuits, concluding that "the wealth effects of shareholder litigation are negligible."[59] While "Romano's study did not separate out suits based on their likelihood of being frivolous or actually merit-driven,"[60] the lack of substantial monetary awards or other substantive relief other than attorneys' fees "provides some support for the possibility that frivolous suits may drive many shareholder lawsuits."[61]

At the same time that Romano was arguing "that shareholder litigation is a weak, if not ineffective, instrument of corporate governance"[62] doing little to advance the interests of shareholders, Janet Cooper Alexander advanced a sweeping argument that, for much stockholder litigation, "[t]he strength of the case on the merits . . . becomes irrelevant to the amount of the settlement . . . ."[63] Alexander examined a set of securities fraud cases involving a group of similar computer company IPOs in the early 1980s.[64] She found that every company that suffered a market loss of at least $20 million was sued and that "the settlement amounts could be approximated without knowing any information other than the number of shares sold in the offering and the stock price at the beginning and end of the class period."[65] From this, Alexander concluded that the merits of the claims—the likelihood that the plaintiffs could show fraud and the amount of damage caused by such fraud—were irrelevant both to the decision to bring suit and to the outcome.[66] While Alexander's sample contained only a specific type of securities fraud class action, she speculated that the similar incentive structures involved in derivative litigation made it an "obvious candidate" for being non-merits-related.[67]

A number of studies have attempted to use the passage of the PSLRA to measure the incidence of frivolous shareholder litigation, with somewhat

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[56] *Id.* at 60. Combined with data on defendants' legal expenses, Romano concludes that it is "plain that the principal beneficiaries of cash payouts in shareholder suits are attorneys." *Id.* at 65.

[57] *See id.* at 61.

[58] *Id.* at 62–64.

[59] *Id.* at 68.

[60] Choi, *supra* note 2, at 1486.

[61] *Id.* at 1484–85.

[62] Romano, *supra* note 1, at 84.

[63] Alexander, *supra* note 1, at 505.

[64] *Id.* at 514–15.

[65] *Id.*

[66] *See id.* at 500.

[67] *Id.* at 597.

conflicting results.[68] One line of inquiry has been to examine the reaction of stock prices to the law's passage, to see if they rose as a result of the hoped-for reduction of frivolous claims.[69] Katherine Spiess and Paula Tkac, for example, found that a sample of high-litigation-risk firms experienced significant negative abnormal returns surrounding President Clinton's veto of the PSLRA and positive abnormal returns upon Congress's override of the veto,[70] thus supporting "the hypothesis that the market viewed the PSLRA as providing a net benefit to the wealth of shareholders"[71]—presumably in part by curtailing previously prevalent meritless litigation. Spiess and Tkac attempted to bolster this conclusion by looking for differential stock price reactions based on the likelihood of firms facing *meritorious* suits, with largely inconclusive results.[72]

Marilyn Johnson, Ron Kasznik, and Karen Nelson undertook a similar event study with a somewhat different sample of companies and a different methodology for assessing the risk of meritless litigation.[73] They again found evidence that the PSLRA increased shareholder wealth in industries at high risk for frivolous litigation.[74] They then sought to correlate the benefits of the PSLRA to firm-specific risk of meritless litigation, finding evidence that the PSLRA reduced shareholder wealth slightly by making even meritorious suits more difficult, "but that these negative effects were dominated, on average, by the positive wealth effects associated with restricting frivolous securities litigation."[75] Again, this finding suggests that—at least prior to the passage of the PSLRA—the negative effects of frivolous litigation outweighed the positive effects of meritorious litigation.

Ashiq Ali and Sanjay Kallapur, however, draw very different conclusions from their event study on the passage of the PSLRA.[76] By adding several additional key dates to their study when events occurred either increasing or decreasing the likelihood of the PSLRA's passage and by reinterpreting what information reached the market on dates examined in prior studies, Ali and

[68] *See* Choi, *supra* note 2, at 1477–82 (summarizing several event studies and concluding that "[t]he event study evidence surrounding the passage of the PSLRA is thus somewhat inconclusive").

[69] *See id.* at 1477 ("In theory, if frivolous suits represented a large cost to companies and the PSLRA worked effectively to reduce such frivolous suits, the stock market price of companies should have reacted positively to the enactment of the PSLRA.").

[70] D. Katherine Spiess & Paula A. Tkac, *The Private Securities Litigation Reform Act of 1995: The Stock Market Casts Its Vote*, 18 MANAGERIAL & DECISION ECON. 545, 554 (1997).

[71] Choi, *supra* note 2, at 1478.

[72] *See* Spiess & Tkac, *supra* note 70, at 555–59.

[73] *See* Marilyn F. Johnson et al., *Shareholder Wealth Effects of the Private Securities Litigation Reform Act of 1995*, 5 REV. ACCT. STUD. 217, 222–29 (2000).

[74] *Id.* at 223–26.

[75] *Id.* at 229.

[76] *See* Ashiq Ali & Sanjay Kallapur, *Securities Price Consequences of the Private Securities Litigation Reform Act of 1995 and Related Events*, 76 ACCT. REV. 431, 456 (2001).

Kallapur arrived at the conclusion that the PSLRA likely reduced shareholder value for high litigation risk firms.[77] This result is consistent with the view that the PSLRA caused more harm by hampering meritorious litigation than benefit by restricting frivolous litigation.

In addition to these event studies examining the actual passage of the PSLRA, Marilyn Johnson, Karen Nelson, and A.C. Pritchard conducted an influential study[78] examining stock reactions to *In re Silicon Graphics*,[79] a landmark Ninth Circuit ruling that imposed an especially "stringent interpretation" of the PSLRA's particularity standard for pleading.[80] They found that the decision generated significant positive abnormal returns for a sample of firms facing a high litigation risk and that the abnormal return was substantially larger for firms within the Ninth Circuit.[81] Furthermore, they found that firms facing the highest risk of non-merit-based litigation experienced the largest abnormal positive returns in reaction to the ruling.[82] These results are consistent with the hypothesis that frivolous litigation imposes significant costs on firms and steps to curtail such litigation can bring substantial gains to stockholder welfare.

While the event studies are suggestive, a number of other studies have attempted to focus more directly on the characteristics of shareholder litigation and the determinants of their outcomes. Jennifer Francis, Donna Philbrick, and Katherine Schipper examined ninety-one securities class actions brought between 1988 and 1991.[83] They found that larger firms tended to attract more litigation, but that litigation did not appear to target "less financially prosperous" firms.[84] They also found that targets of lawsuits tended to have higher beta than peer firms, though they did not experience higher incidence of large price drops.[85] In a similar study, Christopher Jones and Seth Weingram found that high market capitalization, large share turnover, and lower returns

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[77] *Id.* at 442–46, 456.

[78] *See* Marilyn F. Johnson et al., In re Silicon Graphics Inc.*: Shareholder Wealth Effects Resulting From the Interpretation of the Private Securities Litigation Reform Act's Pleading Standard*, 73 S. CAL. L. REV. 773, 773–77 (2000).

[79] *In re* Silicon Graphics Inc. Sec. Litig., 183 F.3d 970 (9th Cir. 1999).

[80] Choi, *supra* note 2, at 1482.

[81] Johnson et al., *supra* note 78, at 794–95.

[82] *Id.* at 798–99.

[83] Jennifer Francis et al., Determinants and Outcomes in Class Action Securities Litigation 2 (Aug. 1994) (unpublished manuscript) (on file with authors).

[84] *See id.* at 11–12.

[85] *See id.* at 12. Beta is a measure of a stock's sensitivity to changes in the overall market. A stock with a beta of one, for example, can—on average—be expected increase in value by 1% for every 1% increase in the broader market, while a stock with a beta of two can—on average—be expected to increase by 2% for every 1% increase in the market.

are all positively correlated with the risk of a securities fraud class action.[86] Neither study focused explicitly on the merits of a typical shareholder suit.

James Bohn and Stephen Choi, on the other hand, attempted to assess whether the merits affected either the incidence of litigation or the settlement outcomes for suits involving all IPOs from 1975 to 1986.[87] They found mixed evidence as to the importance of the merits.[88] Suits were somewhat more likely against firms with high quality underwriters, which they interpret to suggest that suits tend to target deep pockets rather than lower-quality issuances.[89] They also find that a crude model of the potential damages provided just as good a prediction of the ultimate settlement amount as a more sophisticated model assessing the particular allegations of fraud or mismanagement, consistent with the proposition that the merits do not play an important role.[90] They do, however, provide some evidence that firms facing a lawsuit had weaker corporate governance structures when compared to firms that were not sued.[91]

David Gilbertson and Steven Avila examined 314 securities class actions filed from 1990 to 1993.[92] They looked at the time between the date when the alleged fraud was revealed to the market and the filing of the lawsuit, finding that more than half of the claims were brought within one week of the end of the class period.[93] They interpret the fact that a large percentage of claims are "filed within hours or days" as "reinforc[ing] the belief that they are filed indiscriminately," without regard for the merits.[94]

Several studies have examined securities class actions pre- and post-PSLRA, attempting to determine whether the PSLRA has had the desired effect of increasing the importance of the merits. Johnson, Nelson, and Pritchard, for example, examined a set of 119 lawsuits filed from 1991 to 2000.[95] They found that before the PSLRA larger firms were disproportionately targeted for litigation, while the presence of large insider share holdings was the only merit-

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[86] Christopher L. Jones & Seth E. Weingram, *The Determinants of 10b-5 Litigation Risk* 2–3 (John M. Olin Program in Law & Econ., Stanford Law Sch., Working Paper No. 118, 1996).

[87] James Bohn & Stephen Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 903, 909 (1996).

[88] *Id.* at 950.

[89] *Id.* at 950–52.

[90] *See id.* at 971–76.

[91] *See id.* at 962–70.

[92] David L. Gilbertson & Steven D. Avila, *The Plaintiffs' Decision to Sue Auditors in Securities Litigation: Private Enforcement or Opportunism?*, 24 J. CORP. L. 681, 687 88 (1999).

[93] *See id.* at 692.

[94] *Id.* at 690 (internal quotation marks omitted).

[95] Marilyn F. Johnson et al., *Do the Merits Matter More? Class Actions Under the Private Securities Litigation Reform Act* 11–12 (John M. Olin Program in Law & Econ., Univ. of Mich., Working Paper No. 02-011, Stanford Law Sch., Working Paper No. 249, 2002), *available at* http://papers.ssrn.com/abstract=349500.

related variable that correlated with a higher incidence of litigation.[96] Post-PSLRA, they found that other merit-related variables—including accounting restatements and net insider trading—became significantly correlated with the risk of a lawsuit.[97] They also found that, post-PSLRA, an accounting restatement (a proxy for fraud) was positively correlated with a high-value settlement, defined as a settlement greater than $2 million.[98] The authors interpret their results as evidence that the PSLRA succeeded in increasing the importance of the merits in filing and settlement decisions.[99]

Mukesh Bajaj, Sumon Mazumdar, and Atulya Sarin examined a set of 2,700 securities class actions filed from 1988 to 1999 in federal and state courts, and found that the average time to settlement increased markedly following passage of the PSLRA.[100] Whereas prior to the PSLRA, nearly 60% of cases settled within four years, post-PSLRA only about one-quarter of suits settled so quickly.[101] The number of very fast settlements (less than a year) also dropped from 2.67% of cases to only 0.67%.[102] They also found that settlement size was correlated to the length of time from filing to settlement, and that the average settlement size was substantially larger in the post-PSLRA period.[103] To the extent that smaller, quicker settlements represent potentially frivolous suits brought for nuisance values, these findings support the notion that the PSLRA substantially diminished frivolous securities claims.

In sum, the existing literature suggests a substantial volume of frivolous—or at least non-merits-related—shareholder litigation in the pre-PSLRA world, and that the PSLRA may have gone some way towards ameliorating the problem with regard to securities class actions.[104] Of course, any improvements

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[96] *See id.* at 17–18.

[97] *Id.* at 20.

[98] *Id.* at 22.

[99] *Id.* at 23.

[100] Mukesh Bajaj et al., *Securities Class Action Settlements: An Empirical Analysis*, 43 SANTA CLARA L. REV. 1001, 1003, 1010 (2003).

[101] *Id.* at 1010.

[102] *Id.*

[103] *Id.* at 1012, 1022–23 (finding mean and median settlements were $18.09 million and $4.24 million, respectively, in the post-PSLRA period, as compared to $8.01 million and $3.5 million, respectively, in the pre-PSLRA period).

[104] *See* Choi, *supra* note 2, at 1498 ("In sum, the existing literature on filings and settlements in the post-PSLRA time period provide evidence that frivolous suits existed prior to the PSLRA and that a shift occurred in the post-PSLRA period toward more meritorious claims."). Choi goes on to suggest that the PSLRA may have also made it more difficult to bring *meritorious* claims, as well, calling into question whether the PSLRA can be considered an unalloyed good. *See id.*; Curtis & Morley, *supra* note 2, at 280 ("Our sense of this literature is that although a few studies have suggested that the relationship between merits and outcomes is weak, there appears to be a growing consensus that the relationship is reasonably strong." (citation omitted)); *see also* Choi, *supra* note 7, at 598; Eric Talley & Gudrun Johnsen, *Corporate Governance, Executive Compensation and Securities Litigation* 1 (John M. Olin Foundation, Univ. S. Cal. CLEO Research Paper No. 04-4, Univ. S. Cal. Law & Econ. Research Paper, 2004). Cox and Thomas also found that the ratio of

wrought by the PSLRA are restricted to securities class actions, leaving other forms of shareholder litigation largely unaffected.

C. *Problematic Proxies for the Merits of Shareholder Suits*

The studies canvassed above all suffer from a common problem—the use of unreliable proxies for the merits of a given claim. The difficulty in assessing the merits of claims more directly is plain and has long been recognized. In a typical securities class action, for example, it will be difficult or impossible to ascertain whether the defendants in fact violated the securities laws—by committing fraud, for example. It will be more difficult still to evaluate the strength of the plaintiffs' evidence of violations in an objective fashion that facilitates easy comparison among cases. The same is true in a typical stockholder derivative claim. It is also likely to be impossible to determine the value of any settlement in a straightforward fashion, given the likelihood that a settlement will contain potentially important non-monetary terms.

Professor Alexander summarized the problem as follows:

> By definition, settled cases are not adjudicated on the merits, and any attempt to evaluate their merits in hindsight would be unsatisfactory. One could not simply ask the parties or their lawyers to estimate the strength of their cases. Even if their responses were subjectively truthful, their perceptions would be colored by their adversarial role. Nor could the researcher make an independent judgment of the merits. Even if the resources were available to assimilate huge quantities of factual information and legal analysis, the researcher could not gain complete access to the relevant material. And even if these obstacles could be surmounted, the conclusions of such a study would ultimately amount to little more than the researcher's subjective view of the merits.[105]

Alexander sought to surmount the difficulty she identified by restricting her study to a small group of cases—all involving allegations of securities fraud for computer company IPOs during a short time period—and simply assuming that the cases varied in their merits, but they were otherwise identical in relevant aspects.[106] While plausible, the problem with this method was twofold. First, it resulted in a sample size so small (only six settled cases) as to render statistical

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settlements to their calculation of "provable" losses actually declined in the post-PSLRA period. Cox & Thomas, *supra* note 2, at 1637.

[105] Alexander, *supra* note 1, at 506 (footnote omitted); *see also* Choi, *supra* note 2, at 1477 ("Whether lawsuit filings are frivolous or meritorious is particularly difficult to assess."); Cox & Thomas, *supra* note 2, at 1636 (referring to "the difficulty of controlling for all aspects of quality").

[106] Alexander, *supra* note 1, at 500, 506 ("We can approximate [a] laboratory experiment if we can find a sample group of actual cases that are sufficiently similar and that can be expected to vary as to their merits.").

significance a distant dream.[107] Second, as Alexander acknowledged, her methodology left open the very real possibility that all of the cases were equally meritless—that each of the sued companies failed without anyone committing actionable fraud.[108]

To overcome these problems, all of the studies discussed above rely to some extent on proxies—often quite crude proxies—for merit.[109] One commonly employed strategy is to examine settlement outcomes and assume that suits with low recoveries are meritless nuisance claims. Romano, for example, relies heavily on the fact that most settlements provide little financial benefit to shareholders, and only cosmetic governance changes.[110] A number of studies use a dollar amount—usually around $2 million[111]—or a percentage of firm size[112] as a cut-off for whether they consider a claim to be meritorious. Cases with settlements below the cut-off are declared nuisance suits, while cases with settlements above the cut-off are declared meritorious.

Such a proxy, however, is at best only a "rough approximation,"[113] one that is both over- and under-inclusive.[114] The price a defendant is willing to pay to settle a nuisance claim will depend on the costs of defending the claim and the

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[107] *See* Cox, *supra* note 2, at 503 ("[O]ne may wonder whether it is appropriate ever to draw such a sweeping conclusion from a sample as slender as that used by Professor Alexander . . . ."). Cox also expresses doubt over Alexander's failure to take into account the ability of some of the defendants to mitigate their damages by showing that some of the market decline was unrelated to their alleged misrepresentations. *Id.*; *see also* Weiss & Beckerman, *supra* note 41, at 2083–84.

[108] Alexander, *supra* note 1, at 514 n.53 ("The cases could all be of equal merit, of course, if they all had no merit (that is, if no securities laws were broken)."). Of course, even if the cases were all of zero merit, Alexander would have identified a real problem—the routine filing and settlement of nuisance claims. *Id.* at 523 ("This explanation raises a different, but equally troubling, set of questions.").

[109] *See* Choi, *supra* note 2, at 1477 ("Tests of frivolous litigation have focused on a number of indirect measures."); *id.* at 1477 n.36 ("[P]laintiffs' attorneys are unlikely to admit to filing a frivolous lawsuit. Indirect proxies for frivolous lawsuits must therefore be found.").

[110] Romano, *supra* note 1, at 84–85.

[111] *See, e.g.*, Choi, *supra* note 7, at 613 ("I treat suits that result in a settlement of over $2 million as 'nonnuisance.'"); Joseph A. Grundfest, *Why Disimply*, 108 HARV. L. REV. 727, 740–43 (1995) (treating settlements for less than $2,500,000 to $1,500,000 as "nuisance" on the grounds that "the merits may not have mattered at all in the resolution of the litigation"); Johnson et al., *supra* note 95, at 22 (using a $2 million cut-off); Bajaj et al., *supra* note 100, at 1022–23 (using settlement size as a proxy for the merits).

[112] *See, e.g.*, Choi, *supra* note 7, at 614 (using settlements for more than 5% of IPO value as a proxy for non-nuisance suits); Johnson et al., *supra* note 95, at 4 (using settlement amount over market capitalization as a proxy for a nuisance suit).

[113] *See* Choi, *supra* note 7, at 613.

[114] On over-inclusive proxies, see *id.* ("[S]ettlements under $2 million may include both nuisance and nonnuisance suits . . . ."). On under-inclusive proxies, see *id.* at 614 ("It is possible that a company that engaged in a large IPO may settle a nuisance suit for an amount greater than $2 million simply to avoid the distraction of litigation and the risk that an errant jury may award significant damages based on the large IPO amount.").

risk of an erroneous decision leading to large damages, either of which could easily exceed $2 million. As such, studies showing larger settlement sizes in the post-PSLRA period[115] may simply reflect—to take only the most obvious example—an increase in discovery costs with the rise of e-mail and electronic discovery that just happened to occur in the same general time period,[116] rather than any increase in the merits of securities claims. Perhaps even more problematic, while the prevalence of small settlements may suggest a lack of meritorious claims, it "is equally consistent with the view that highly meritorious suits are brought, but settled for too little."[117]

Using the speed with which a lawsuit is brought as a proxy for nuisance suits is similarly problematic.[118] A quick filing may indicate a lack of investigation and a cavalier attitude towards the merits. But a highly meritorious case of flagrant wrongdoing would likely require little preliminary investigation and also result in quick filings.[119]

Other proxies for the merits are perhaps better, but still extremely crude. Any event study around the passage of the PSLRA is faced with all the usual uncertainties attendant upon any event study based on a legislative event that is, in fact, a series of smaller events of varying degrees of importance and predictability.[120] Furthermore, such studies are, at best, attempting to measure the sum of at least three confounding variables that may partially overlap or offset each other: (1) the extent to which companies were harmed by frivolous litigation prior to the PSLRA, (2) the effectiveness of the PSLRA in reducing the harm of frivolous litigation, and (3) the extent to which the PSLRA reduced the benefits of meritorious litigation.[121]

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[115] *See, e.g.*, Bajaj et al., *supra* note 100, at 1022–23.

[116] *See, e.g.*, John H. Beisner, *Discovering a Better Way: The Need for Effective Civil Litigation Reform*, 60 DUKE L.J. 547, 564–72 (2010) (describing the escalating costs of discovery involving e-mail and other electronic records); AM. COLL. OF TRIAL LAWYERS TASK FORCE ON DISCOVERY & INST. FOR THE ADVANCEMENT OF THE AM. LEGAL SYS., INTERIM REPORT, app. at A-4 (2008) (reporting that 87% of respondents to a survey of the fellows of the American College of Trial Lawyers claimed that electronic discovery "increases the cost of litigation").

[117] Cox, *supra* note 2, at 502.

[118] *See* Gilbertson & Avila, *supra* note 92, at 681, 690, 694.

[119] *See* Choi, *supra* note 2, at 1491–92 ("[Quick filings] are not necessarily inconsistent with meritorious litigation. Some types of claims . . . may involve large amounts of public evidence of fraud immediately at the end of the class period, if not before. For such meritorious claims, further investigation on the part of the plaintiffs' attorneys may be unnecessary prior to the filing of suit, leading to short filing times.").

[120] The passage of the PSLRA, at a minimum, involved the initial congressional passage of the bill, President Clinton's veto of the bill, the House override of the veto, and the Senate override of the veto. *Id.* at 1477. Whenever an event study must deal with a "compound" event of this nature, the statistical correlations become more confused, and the researcher's biases and priors become more problematic. *See* Sanjai Bhagat & Roberta Romano, *Event Studies and the Law: Part I: Technique and Corporate Litigation*, 4 AM. L. & ECON. REV. 141, 145–47 (2002).

[121] *See* Choi, *supra* note 7, at 616.

Nor is it entirely satisfactory to use—as many studies have—market capitalization, share turnover, share performance, and beta or other measures of volatility as proxies for frivolous litigation.[122] The fundamental problem is that these measures will also tend to correlate with meritorious suits[123]—all else being equal, plaintiffs' attorneys (and their clients) would prefer to sue when there is a possibility of a large recovery. As Stephen Choi has pointed out, attorneys would "not wish to file even a meritorious suit against a small market capitalization firm with low stock market turnover to the extent the potential damages from such a suit are low and thus unlikely to compensate the plaintiffs' attorney for the relatively fixed costs of litigation."[124] A large potential recovery may be a necessary condition of even a meritorious claim—perhaps large, meritorious claims are the only ones worth bringing.[125]

Similar shortcomings exist for attempts to correlate merit with the amount of potential damages available. James Cox and Randall Thomas, among others, use as a proxy for merit the ratio of the settlement amount to what they refer to as "provable losses," on the supposition that a small ratio indicates a low-merit claim settled for nuisance value.[126] Models for estimated damages or provable losses vary but generally involve some multiplication of the magnitude of the stock price decline during the class period by the number of affected shares.[127] Such measures are flawed in at least three ways. First, as discussed above, large potential damages may be a necessary condition for both meritorious and frivolous litigation. Second, such estimates can vary widely and may be very sensitive to assumptions used in the model.[128] Finally, and most fundamentally, such measures entirely neglect highly salient aspects of the merits by implicitly rejecting the possibility of non-culpable explanations for stock declines. Instead, they implicitly assume that the relevant losses can be attributed to culpable behavior and that plaintiffs do not differ in their ability to prove such behavior.

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[122] *See* Johnson et al., *supra* note 78, at 807–08; Johnson et al., *supra* note 73 at 223–24; Jones & Weingram, *supra* note 86, at 2–3; Francis et al., *supra* note 83, at 11–12.

[123] *See* Choi, *supra* note 2, at 1480 ("While factors such as market capitalization, minimum return, and stock market beta may correlate with a frivolous suit, they may also correlate with meritorious suits.").

[124] *Id.* at 1480–81.

[125] *Id.* at 1489 ("[M]arket capitalization, volatility, equity beta, and share turnover [] may represent necessary but not sufficient factors for both frivolous and meritorious litigation.").

[126] *See* Cox & Thomas, *supra* note 2, at 1627; James D. Cox & Randall S. Thomas, *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L.J. 737, 768 n.100 (2003); *see also Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 103d Cong. 138–41 (1993) (statement of Vincent E. O'Brien).

[127] *See* Willard T. Carleton et al., *Securities Class Action Lawsuits: A Descriptive Study*, 38 ARIZ. L. REV. 491, 494–97 (1996).

[128] *See id.*; Cox, *supra* note 2, at 505 ("[E]stimates can vary widely for the amount recoverable by the securities class depending not only on what model is employed to estimate damages, but also on what assumptions are used for the model's variables.").

Bohn and Choi use underwriter reputation as a proxy for merit in their study of shareholder suits involving IPOs, theorizing that underwriters with good reputations are less likely to associate with offerings involving violations of securities laws.[129] In addition to depending on the debatable proposition that bulge bracket firms like Goldman Sachs and Lehman Brothers would never commit securities fraud, this proxy for merit is confounded by the fact that higher-quality underwriters tend to associate with larger IPOs.[130] Thus, the finding that high-quality underwriters are (weakly) correlated with a higher incidence of securities litigation could mean either that the merits do not matter or that even meritorious claims are only worth bringing when the potential recovery is large enough.[131]

In their studies, Johnson, Nelson, and Pritchard have used somewhat more direct proxies for merits, looking for corporate characteristics that might be thought to be correlated with a greater incidence of wrongdoing.[132] Among the factors they have used are the power of the CEO, the degree of internal monitoring,[133] the motivation to commit fraud,[134] the presence of an accounting restatement for the firm (along with other measures of aggressive accounting), and the likelihood of insider trading during the class period.[135] These measures are an improvement over the others discussed, in that they are somewhat more closely related to the essential merits question—how likely is it the defendants have committed culpable acts? The measures are nonetheless only loosely related to this question, and estimating the correlation of the selected variable to actual wrongdoing involves a tremendous amount of what can only be described as guesswork.

The only truly satisfying proxy for the merits found in the literature is that used by Quinn Curtis and John Morley in their study of excessive mutual fund fee litigation.[136] In these cases, the only issue is the appropriateness of the funds' fees, which are directly observable and comparable.[137] They find that the strongest predictor of whether a mutual fund would be targeted by such a claim was not the size of the fees charged, but rather the size of the assets under

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[129] Bohn & Choi, *supra* note 87, at 952–55.

[130] *Id.* at 955–57.

[131] *See* Cox, *supra* note 2, at 507 (arguing that Bohn's and Choi's "overall data merely confirms that larger offerings attract not only higher quality underwriters but also cost-conscious class action lawyers").

[132] *See* Johnson et al., *supra* note 78, at 807–08.

[133] Such factors include the number of insiders on the board, the share ownership of outside directors, the presence of an audit committee and the identity of the outside auditor, outside block shareholders, and whether the CEO is also a founder. *Id.*

[134] Such factors include the debt-equity ratio of the firm and whether the firm had recently engaged in outside financing. *Id.*

[135] Johnson et al., *supra* note 95, at 15–18. Among the insider trading variables were the magnitude of trading activity of directors and top officers and the differences in insider trading from prior periods. *See id.*

[136] Curtis & Morley, *supra* note 2, at 275.

[137] *Id.* at 277.

management by the targeted fund's family.[138] They suggest that this may indicate that such litigation is triggered less by a meritorious claim and more by the presence of deep pockets.[139] The great advantage of Curtis and Morley's methodology is that their proxy for the merits (the size of a fund's fee relative to similar funds) is directly related to the key merits issue in the suits they study—whether the fund's fee was excessive. As we explain in Part III, stockholder suits challenging merger transactions offer a similar opportunity because the key merits question is directly related to a variable that is easily observable and comparable.

III. THE STRUCTURE OF STOCKHOLDER MERGER LITIGATION

Stockholder litigation targeting merger transactions offers the possibility of assessing the merits of claims more directly than in earlier studies, without the need to resort to dubious proxies. When stockholders challenge a merger, the only issue that will matter to the typical stockholders of a target corporation is the adequacy of the price they will receive for their shares. This price is directly observable. Moreover, an objective—if still imperfect—measure of its adequacy can be obtained by comparing it to prices in comparable transactions. By examining the adequacy of the merger price in transactions that *do* attract stockholder litigation to the adequacy of the price in transactions that *do not* attract such litigation, we can thus assess the extent to which the merits matter in the decision to bring a claim. We can avoid refracting the inquiry through some proxy that is only tenuously related to the merits or is susceptible to competing interpretations.

The crucial contention, of course, is that the adequacy of the merger price is itself an adequate measure for the merits in stockholder suits challenging a merger. This contention is at least potentially contestable, in that plaintiffs in such suits usually must couch their claims in terms of some form of breach of fiduciary duty.[140] Formally, then, the "merits" of the claim will depend on factual issues and the strength of the evidence that the defendants breached their fiduciary duties. As discussed more fully below, however,[141] questions of breach of fiduciary duty and procedural propriety in this context are themselves primarily proxies for the underlying adequacy of the merger consideration. For the target company, a merger is an end-period transaction.[142] The stockholders

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[138] *Id.* at 276.

[139] *Id.* at 288.

[140] R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 9.37 (3d ed. Supp. 2012) ("The alternative to an appraisal is generally a stockholder class action challenging a transaction as a breach of the target director's fiduciary duties.").

[141] *See infra* Part III.B.

[142] Stephen M. Bainbridge, Unocal *at 20: Director Primacy in Corporate Takeovers*, 31 DEL. J. CORP. L. 769, 836 n.283 (2006) ("From the perspective of the relationship between

of the firm who are being merged out of existence will typically have no ongoing relationship with the existing directors or management. The kinds of governance reforms typical in settlements of other forms of stockholder litigation will be of no value in takeover litigation, and additional disclosure will be only of interest to the extent that it leads to a higher merger price.[143] Whatever the procedural defects of a transaction, a challenge is only in the stockholders' interests if there is reason to believe they are not receiving sufficient consideration. If the adequacy of the merger consideration is not the *sole* issue in determining whether a suit should be brought, it should at the very least be an important one.

This Part introduces the major forms of stockholder merger litigation. First, we introduce the fiduciary class action and explain how such actions share the structural agency problems common to most forms of stockholder litigation. We also argue that the adequacy of the merger consideration is an excellent measure of the merits of such claims. Second, we introduce the appraisal action, whereby stockholders can refuse the merger consideration and request a court to calculate the "fair value" of their shares. We also argue that the structure of appraisal litigation is such that the merits are likely to matter a great deal. In appraisal actions, the adequacy of the merger consideration is the *only* merits issue.

This Part shows how these two similar remedies at merger create very different incentives for stockholders and for plaintiffs' attorneys. In both the fiduciary suit and in the appraisal petition, there is a disgruntled stockholder and an attorney representing the stockholders. In the fiduciary suit, however, the lawyer is the true party-in-interest, and the stockholder serving as plaintiff is relatively unimportant. This situation is potentially the source of much mischief because it may lead plaintiffs' attorneys to initiate and settle fiduciary class claims with little regard for the merits. As we explain, this contrasts with appraisal litigation, where the stockholder is necessarily in the driver's seat. These contrasts enable us to compare the profile of appraisal litigation (where the merits should matter) to that of fiduciary class actions (where there is reason to fear the merits do not matter). This comparison is carried out in Part IV.

A. *Fiduciary Class Actions and Agency Costs in Takeover Litigation*

Delaware courts have long recognized the uniqueness of the situation when a board of directors agrees to a merger. The risks of managerial opportunism are greater in the context of a sale of corporate control than in conventional corporate decisions.[144] Thus, the business judgment rule gives way to enhanced forms of judicial scrutiny that vary depending on the circumstance.

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the board and shareholders of the target corporation, a locked-up negotiated acquisition is a final period transaction.").

143 *See, e.g.*, Cain & Davidoff, *supra* note 9, at 16, 29; Romano, *supra* note 1, at 63.

144 *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) (In control transactions, "[b]ecause of the omnipresent specter that a board may be acting primarily in

If the sale is a friendly one to a third party, the principal risk for shareholders is that managers could sell the firm at a discount to a favored bidder in hopes of obtaining some lucrative post-transaction benefits like continued employment or severance payments. For this reason, Delaware courts will scrutinize the decisions of directors to ensure that the sale of the company lives up to their duties under *Revlon* and its progeny.[145]

When the board sells the company to a controlling shareholder, the risks to minority shareholders are even more acute, and Delaware law imposes a much more demanding level of scrutiny on such transactions. Under *Weinberger v. UOP, Inc.* and later decisions, the transaction must be "entirely fair" to minority shareholders to survive judicial review.[146] Boards have engaged in a wide range of procedural alchemy in an attempt to generate "independence" and avoid this exacting standard of review. For example, then-Chancellor Leo Strine recently used a lenient business judgment rule standard to review a merger with a controlling stockholder because the target company had taken two steps to insulate against any appearance of conflict.[147] The target created an independent negotiating committee and conditioned the transaction on approval by a majority of the minority shareholders.[148]

Delaware also imposes a duty of disclosure on directors in most merger transactions.[149] If directors ask shareholders to vote to adopt the merger agreement, or if they put shareholders in a position where they must decide whether to seek appraisal or accept the merger consideration, Delaware requires

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its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.").

[145] Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 44 (Del. 1994) ("In the sale of control context, the directors must focus on one primary objective—to secure the transaction offering the best value reasonably available for the stockholders—and they must exercise their fiduciary duties to further that end."); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1985) (noting that once directors decide to sell the company, their "role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company").

[146] *See* Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994) ("It is a now well-established principle of Delaware corporate law that in an interested merger, the controlling or dominating shareholder proponent of the transaction bears the burden of proving its entire fairness."); *see also* Nixon v. Blackwell, 626 A.2d 1366, 1374 (Del. 1993); Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983); *In re* John Q. Hammons Hotels Inc. S'holder Litig., No. 758-CC, 2009 WL 3165613, at *2 (Del. Ch. Oct. 2, 2009).

[147] *See In re* MFW S'holders Litig., 67 A.3d 496, 502, 536 (Del. Ch. 2013).

[148] *Id.* at 502.

[149] *See, e.g.*, Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 372 (Del. 1993) ("Delaware corporations have a fiduciary duty to disclose completely all available material information when obtaining shareholder approval." (citing Stroud v. Grace, 606 A.2d 75, 84 (Del. 1992))); *see also* BALOTTI & FINKELSTEIN, *supra* note 140, § 17.2 ("[T]he fiduciary duty of disclosure is not limited to matters requiring a stockholder vote . . . . [And it] is triggered in any situation in which stockholders have a right to appraisal, even if the merger is not one that required their vote . . . .").

that directors "exercise reasonable care to disclose all facts that are material to the stockholders' consideration of the transaction or matter and that are or can reasonably be obtained through their position as directors."[150] A potential remedy for a failure to satisfy the disclosure duty is quasi-appraisal.[151] This still-inchoate doctrine in Delaware can give rise to a supercharged proceeding that mirrors the statutory appraisal remedy, but on behalf of all minority shareholders.[152]

Plaintiffs' attorneys thus have a variety of claims they can deploy against impending mergers. In these merger class actions, the class typically consists of all stockholders, and opting-out is available only in extraordinary circumstances. As in other types of representative shareholder litigation, the costs of bringing the claims can be taxed against any recoveries. This means that the plaintiffs' attorney has the strongest financial stake in the claim, virtually always far outweighing that of any individual stockholder.[153] The chief virtue of this litigation structure is that it creates an incentive for private attorneys to police transactions. Some plaintiffs' attorneys have standing arrangements with shareholder clients, but others must affirmatively seek out shareholders whom they can represent. Once the attorney has located a shareholder who can stand as lead plaintiff, the complaint can be filed in court as a class action on behalf of all stockholders. In theory, then, the claim can result in recovery of the entire loss suffered by the class, thus inducing the optimal level of deterrence.

Merger class actions are a subspecies of the more general class of stockholder claims, which have historically stood as one of the chief corporate law mechanisms for policing misconduct, and which share many structural features.[154] Other common examples are stockholder derivative suits and federal securities class actions. These stockholder suits attempt to ensure the fidelity of directors and managers to the interests of stockholders by enforcing substantive corporate and securities law rules.[155] These stockholder suits

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150 *In re* Wayport, Inc. Litig., 76 A.3d 296, 314 (Del. Ch. 2013).

151 Berger v. Pubco Corp., 976 A.2d 132, 133 (Del. 2009).

152 *Id.* at 137.

153 Suppose, for example, that the median attorneys' fee in settlement of a fiduciary claim is 33% of the recovery. At any public firm, this stake in the outcome dwarfs that of virtually any public shareholder.

154 In an earlier era, the Supreme Court noted that the derivative suit, "born of stockholder helplessness[,] was long the chief regulator of corporate management and has afforded no small incentive to avoid at least grosser forms of betrayal of stockholders' interests." Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949). Without the ability to bring a derivative claim, "there would be little practical check on such abuses." *Id.*; *see also* Eugene V. Rostow, *To Whom and for What Ends Is Corporate Management Responsible?*, *in* THE CORPORATION IN MODERN SOCIETY 46, 48 (Edward S. Mason ed., 1959) (describing the derivative suit as "the most important procedure the law has yet developed to police the internal affairs of corporations").

155 Claire A. Hill & Brett H. McDonnell, *Fiduciary Duties: The Emerging Jurisprudence*, *in* RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW, *supra*

represent one of the chief corporate law mechanisms for addressing managerial agency costs.[156] As noted above, however, even those who praise the opt-out class structure acknowledge the risks associated with the conflict of interest between plaintiffs' attorneys and the shareholder class.[157]

In the merger context, fiduciary class actions have recently become ubiquitous. A 2004 study by Robert Thompson and Randall Thomas first drew attention to the prevalence of merger class actions.[158] During their two-year period of study, they found that merger class actions accounted for more than 60% of the consolidated cases in the Delaware Court of Chancery.[159] More recent research has shown merger class action filings have spread across multiple jurisdictions—meaning that, for example, a Delaware corporation might face identical complaints in Delaware court, its headquarters state's courts, and in federal courts.[160] This type of litigation now touches nearly all public company mergers. One survey of merger litigation in 2012 concluded that 92% of transactions larger than $100 million attracted at least one fiduciary class action.[161]

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note 45 ("The main mechanism by which state corporate law today attempts to patrol the behavior of those running the corporation is the law of fiduciary duty. This law is enforced through shareholder actions, derivative or direct, against those alleged to have violated a duty to the corporation."); *see also* Thomas & Thompson, *Empirical Studies*, *supra* note 45, at 153 ("Shareholder litigation is one of the few structural limits on managerial power provided within corporate law itself.").

156 Sean J. Griffith, *Uncovering a Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors' and Officers' Liability Insurance Policies*, 154 U. PA. L. REV. 1147, 1154–55 (2006) ("Whether shareholders bring a derivative claim alleging a wealth transfer from shareholders to management, a direct action claiming that an entrenched board has not acted to maximize shareholder wealth in the context of a takeover, or a securities claim alleging that managers misstated earnings in order to protect their incentive compensation packages, the underlying issue is the failure of the corporation to design a structure to constrain its managers from acting to benefit themselves at the expense of shareholders. Much shareholder litigation, in other words, arises as a result of managerial agency costs.").

157 *See* GILSON & BLACK, *supra* note 38, at 1268 n.48; Thomas & Thompson, *Empirical Studies*, *supra* note 45, at 155 ("[I]f suits were being driven too much by lawyer interests, representative litigation could result in the attorney initiating suits with little merit, settling strong suits for too little, and structuring the settlement so the costs are not borne by the actual wrongdoers.").

158 *See* Thompson & Thomas, *supra* note 4, at 135.

159 *Id.* at 168.

160 Minor Myers, *Fixing Multi-Forum Shareholder Litigation*, 2014 U. ILL. L. REV. 467, 469.

161 *See* Cain & Davidoff, *supra* note 4, at 1–2; *see also* ROBERT M. DAINES & OLGA KOUMRIAN, CORNERSTONE RESEARCH, SHAREHOLDER LITIGATION INVOLVING MERGERS AND ACQUISITIONS 1 (Feb. 2013), *available at* www.cornerstone.com/files/upload/Cornerstone_Research_Shareholder_Litigation_Involving_M_and_A_Feb_2013.pdf (making similar findings).

B. *Appraisal Litigation*

Appraisal allows a stockholder to dissent from a merger and forego the merger consideration in favor of filing a judicial proceeding to calculate the "fair value" of the stock cancelled in the merger.[162] It traces its origins to basic changes in American corporate law at the beginning of the twentieth century.[163] Older corporate codes had required the unanimous vote of all shareholders before a merger or other fundamental change.[164] Under a unanimity requirement, any individual shareholder—no matter how small—could stand in the way of a transaction and attempt to extort a side payment in return for their assent. This holdout problem became severe as companies sold increasing amounts of stock to the public, and patterns of shareholding became more dispersed.[165] States responded by amending their corporate codes to eliminate the unanimity requirement and replacing it with a majority voting rule.[166] This change, however, stripped minority shareholders of some protection against expropriation by controlling shareholders.[167] The appraisal remedy is traditionally thought to have emerged as a rough replacement.[168] While

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[162] *See generally* DEL. CODE ANN. tit. 8, § 262(a) (2013); 3 MODEL BUS. CORP. ACT ANN. § 13.02 (2013). In this Article, we focus on mergers involving Delaware entities and will, therefore, largely limit the discussion to Delaware law.

[163] Appraisal rights existed in one form or another in a few jurisdictions as long ago as the mid-nineteenth century, but they only became widely available in their modern form in the early-twentieth century. *See* MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 75, 81 (1976).

[164] *See* Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1, 11–14 (1995); Barry M. Wertheimer, *The Shareholders' Appraisal Remedy and How Courts Determine Fair Value*, 47 DUKE L.J. 613, 618–19 (1998).

[165] *See* William J. Carney, *Fundamental Corporate Changes, Minority Shareholders, and Business Purposes*, 1980 AM. B. FOUND. RES. J. 69, 79–82 ("It became increasingly apparent to observers that great benefits to society, to the corporation, and derivatively to the rest of the shareholders were sometimes blocked to protect interests that seemed quite minor . . . to the remaining shareholders and perhaps to most outsiders."); Thompson, *supra* note 164, at 12–13.

[166] *See* Carney, *supra* note 165, at 94 ("Over the first third of the twentieth century the pattern of allowing fundamental changes in all corporations to take place on something less than a unanimous shareholder vote became the norm . . . .").

[167] *See* Thompson, *supra* note 164, at 11–13.

[168] *See, e.g.*, George S. Geis, *An Appraisal Puzzle*, 105 NW. U. L. REV. 1635, 1642 (2011) ("[Appraisal] mushroomed in the early 1900s, when state lawmakers granted appraisal rights to shareholders—apparently in exchange for an easing of merger voting requirements.") (footnote omitted)); Thompson, *supra* note 164, at 14 ("Appraisal statutes are often presented as having been enacted in tandem with statutes authorizing consolidation or merger by less than unanimous vote."); Wertheimer, *supra* note 164, at 614 ("The origin of the appraisal remedy typically is tied to the move in corporate law . . . away from a requirement of unanimous shareholder consent."); *see also* Joseph L. Weiner, *Payment of Dissenting Stockholders*, 27 COLUM. L. REV. 547, 548 n.7 (1927) (listing states that enacted an appraisal remedy in the early-twentieth century). *But see* Mahoney & Weinstein, *supra*

minority stockholders can no longer block a transaction they view as disadvantageous, appraisal affords them an opportunity to exit from their investment on terms set by a court rather than the majority shareholders.[169]

The triggering events for appraisal rights differ from one state to another. In Model Business Corporation Act states, appraisal rights are available in the event of multiple types of transformational changes, including a merger, a sale of assets, or an amendment to the certificate of incorporation.[170] In Delaware, by contrast, only mergers give rise to appraisal rights.[171] Because our principal interest in appraisal here is to serve as a comparison to other forms of Delaware merger litigation, we restrict our attention to appraisal proceedings involving Delaware-incorporated targets. For public companies, the form of consideration also affects eligibility for appraisal. If the merger consideration is cash, appraisal is available, but it is not available when shareholders receive stock in the surviving entity.[172] Even when a transaction gives rise to appraisal rights, stockholders must affirmatively comply with a series of procedural requirements to preserve their ability to pursue the remedy. In Delaware, the stockholder must not vote in favor of the merger,[173] must make a written demand for appraisal and deliver it to the company,[174] and must file within 120 days of the effective date of the merger.[175]

Appraisal in Delaware can offer an alternative avenue of redress for minority shareholders who believe that the price being offered for their shares in a merger transaction is too low. As such, appraisal can address, in a rough way, the same general wrong that other forms of merger litigation seek to address: failure to obtain a high enough price in the sales process. This is the alleged misdeed at the bottom of *Revlon* claims, entire fairness claims, and

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note 16, at 243 (questioning whether appraisal statutes were a direct reaction to elimination of unanimity requirements).

[169] *See* Geis, *supra* note 168, at 1643 ("[A]ppraisal rights were therefore enacted in most jurisdictions as an emergency exit from majority rule. A merger could move forward with less-than-unanimous approvals, but minority owners had an escape if they disliked the shift in direction."); Thompson, *supra* note 164, at 21. In this respect—as in others—appraisal is a highly unusual remedy in corporate law. Shareholders do not, under normal circumstances, have the power to withdraw their proportional interest from the firm's assets. *See* Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 434–35 (2000). Appraisal represents an unusual opportunity for shareholders to, in effect, withdraw their interest in the firm without having to sell their shares on a secondary market.

[170] *See* 3 MODEL BUS. CORP. ACT ANN. § 13.02(a) (2013).

[171] *See* DEL. CODE ANN. tit. 8, § 262(b) (2013). For purposes of comparison to merger litigation, we will restrict consideration to appraisal involving mergers.

[172] *Id.*

[173] *Id.* § 262(a).

[174] *Id.* § 262(d)(1). Such a demand is usually simply a short statement informing the issuer of the number of shares held and the intent to seek appraisal.

[175] *Id.* § 262(e). A shareholder who makes demand need not ultimately file a petition for appraisal because the shareholder retains the right to back out and take the merger consideration within sixty days of the effective date of the merger. *Id.*

appraisal claims alike, and the principal reason—if not *only* reason—a typical shareholder might wish to pursue any of these claims.

Unfortunately, appraisal has not previously been the subject of sustained empirical investigation, perhaps because it has long been regarded in the corporate law literature as a peripheral and rarely useful remedy.[176] Victor Brudney and Marvin Chirelstein, for example, called it a "last-ditch check on management improvidence,"[177] and Melvin A. Eisenberg described it as a "remedy of desperation."[178] What little empirical work has been done has tended to suggest that the appraisal remedy is not a particularly consequential form of shareholder litigation; Paul Mahoney and Mark Weinstein found no evidence that the availability of appraisal is associated with higher merger premiums for target shareholders.[179] While practitioners have in recent years suggested that appraisal is an increasingly active area,[180] academic commentary has remained sweepingly dismissive. The conventional wisdom remains that appraisal is seldom utilized,[181] and the hurdles involved make it too cumbersome for the "typical" shareholder to profitably call upon.[182] As one

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[176] Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 260 (1962) ("The appraisal remedy is of virtually no economic advantage to the usual shareholder except in highly specialized situations.").

[177] Victor Brudney & Marvin A. Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 304 (1974).

[178] Melvin Aron Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking*, 57 CALIF. L. REV. 1, 85 (1969).

[179] Mahoney & Weinstein, *supra* note 16, at 242–43.

[180] *See e.g.*, 2 EDWARD P. WELCH ET AL., FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 262.1 (5th ed. Supp. 2009) (noting that "[t]he appraisal right is alive and well" and contrasting that assessment with that of the first edition of the treatise); David J. Berger, *The Growth of Appraisal Litigation in Delaware*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (Dec. 5, 2013, 9:11 AM), http://blogs.law.harvard.edu/corpgov/2013/12/05/the-growth-of-appraisal-litigation-in-delaware/, *archived at* http://perma.cc/G55W-3AL8 (noting a "growing tendency of institutional and other large investors to exercise their appraisal rights under Delaware law").

[181] *See* 2 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS ch. 4, intro. note (1994).

[182] "[Appraisal] is rarely the remedy of other than the 'wine and cheese' crowd, for seldom is appraisal sought by investors whose holdings are less than $100,000 . . . ." COX ET AL., *supra* note 15, at 595–96. Of course, the vast bulk of most corporate securities are held by individuals and entities owning greater than $100,000, so we immediately sense that some of the criticisms may not be quite as devastating as the critics believe. For representative statements, however, of the conventional wisdom on the uselessness of appraisal, see, for example, Aronstam et al., *supra* note 15, at 546 ("[I]n practice, the appraisal remedy is replete with shortcomings and therefore fails to protect adequately minority shareholders from majoritarian abuse."); Coffee, Jr., *supra* note 15, at 412 ("Standing alone, the appraisal remedy cannot begin to assure the receipt of proportionate value."); Fried & Ganor, *supra* note 15, at 1005 ("The shortcomings of the appraisal remedy are widely known. Commentators have long recognized that appraisal is a remedy that few shareholders will seek under any circumstance."); Seligman, *supra* note 15, at 830 (arguing that appraisal suffers from "substantial defects in the ability of state corporate law to ensure

Delaware opinion noted, appraisal is "chock-full of disadvantages for shareholders."[183]

Whatever the merits of appraisal as a standalone tool of corporate governance,[184] it offers an excellent opportunity to investigate the merits of shareholder litigation. As explained below, appraisal actions have a number of structural features that are unique among shareholder litigation, and which combine to make it highly likely that the merits will matter a great deal in the decision to bring an appraisal claim. Because the sole issue in an appraisal claim—the fair value of the petitioner's shares—largely overlaps with the most important practical issue in other forms of merger litigation, appraisal can serve as a benchmark against which to assess the merits in those other forms of merger litigation.

In particular, the very "disadvantages" that have led commentators to be dismissive of appraisal—the inability to proceed as a class, the expense and difficulty of bringing a claim, and the narrow remedy—may make appraisal a uniquely merit-driven form of litigation. Appraisal actions are not representative in nature. As noted above,[185] in a typical stockholder class action, a stockholder who does not want to be represented must affirmatively opt-out of the proceedings.[186] By contrast, appraisal petitioners must affirmatively opt in

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dissenting shareholders the fair value of their shares"); Subramanian, *supra* note 15, at 31 ("[I]t is well accepted among academic commentators and practitioners that appraisal is a weak remedy compared to entire fairness review."); *see also* COX ET AL., *supra* note 15, at 601 ("[T]he risk of considerable expense as well as the procedural difficulties in pursuing the [appraisal] remedy further decrease its effectiveness in protecting minority shareholders."); 2 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS ch. 4, intro. note (1994) ("The practical utility of the appraisal remedy as a protection for minority shareholders has been the subject of much debate, and few legal commentators have been confident that the remedy works sufficiently well to play a major role in corporate governance."). In a 2007 article, however, Kahan and Rock observed that hedge funds have pursued appraisal actions as a last resort. Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1038 39 (2007) (noting that "[w]hen hedge funds are dissatisfied with the terms of an acquisition and unable to obtain better terms, they also resort to litigation" and giving examples).

[183] Turner v. Bernstein, 776 A.2d 530, 547 (Del. Ch. 2000). These disadvantages tend to fall into three categories: (1) the procedural burdens of preserving and asserting an appraisal remedy; (2) the inability to proceed as a class and shift attorneys' fees; and (3) the narrow and inflexible nature of the remedy available. As noted in the text, these "disadvantages" are great advantages in using the merits of appraisal actions as a benchmark for other merger litigation.

[184] We evaluate those merits in another paper and conclude—contrary to the conventional wisdom—that appraisal actions hold out substantial promise as a tool of corporate governance. *See* Korsmo & Myers, *supra* note 18 (manuscript at 1).

[185] *See supra* Part III.A.

[186] *See In re* Celera Corp. S'holder Litig., 59 A.3d 418, 434–36 (Del. 2012) (describing the limited circumstances where stockholders can opt-out of merger class actions certified under Rule 23(b)(2)).

to a proceeding by complying with the procedural requirements of the appraisal statute.[187] Because appraisal petitioners are required to abstain or vote against the merger and to give notice of intent to demand appraisal, the process of "opting in" begins well before a petition is ever filed.[188]

The lack of a class mechanism has at least two important consequences. First, because the costs of the proceeding cannot be spread across the class,[189] it is not possible in an appraisal proceeding to follow the typical shareholder suit pattern of an entrepreneurial plaintiffs' attorney making an arrangement with a small shareholder and seeking to represent a class of all shareholders.[190]

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[187] *See* DEL. CODE ANN. tit. 8, § 262 (2013); Thompson, *supra* note 164, at 41 ("No provision is made for a class action or other means that would permit shareholders in a common situation to share an attorney and other expenses of litigation easily.").

[188] *See, e.g.*, Ala. By-Products Corp. v. Cede & Co. *ex rel.* Shearson Lehman Bros., Inc., 657 A.2d 254, 260 n.10 (Del. 1995) ("In an appraisal proceeding, however, shareholders enter the appraisal class by complying with the statutory formalities required to perfect their appraisal rights. Thus, shareholders seeking appraisal 'opt in' to a class, invariably before suit is even filed, rather than 'opt out.'"); 2 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7 (1994) ("[T]he appraisal remedy differs from the procedural rules applicable to the class action, which assume that investors who do not 'opt out' desire to be represented."); Aronstam et al., *supra* note 15, at 547 ("[T]he appraisal statute creates an 'opt-in' class for minority shareholders as opposed to the 'opt-out' default mechanism of class action lawsuits. Thus, only shareholders specifically electing to opt in will be able to benefit from a judicial determination diverging from the corporation's initial valuation."); *see also, e.g.*, Fried & Ganor, *supra* note 15, at 1004 n.105 ("In Delaware, shareholders seeking appraisal are barred from using class action suits. Because each shareholder must pursue his own individual claim, shareholders lose the important economic benefits of class actions, which spread the costs of litigation and facilitate contingency financing.").

[189] *See, e.g.*, WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 215 (9th ed. 2004) ("[T]he appraisal remedy lacks the class action's ability to secure automatic representation and a greater recovery for shareholders.").

[190] Gilson & Black describe the dynamic in a typical shareholder suit as such:

> Most important[ly], the [fiduciary duty] suit can be brought as a class action. Minority shareholders need take no affirmative action in order to participate, nor need they expend any resources to pursue the action. All the responsibility—both for initiating the action and for its expenses—is borne by the self-designated lawyer for the class who is compensated, one way or the other, out of the amount recovered. The lawyer then stands, in effect, as an independent investor who balances his estimate of the potential recovery to all shareholders against the cost of the proceeding and the uncertainty associated with its outcome.

GILSON & BLACK, *supra* note 38, at 1267. Similarly, Mary Siegel notes the following:

> Just as shareholders have financial incentives to pursue non-appraisal actions, plaintiffs' attorneys are similarly motivated by the size of potential fees. While most jurisdictions provide that attorneys' fees in appraisal awards may be apportioned from the recovery, as are fees in class actions, these equivalent structures often do not produce equivalent results. The potential amount of the attorneys' fees—and therefore

Instead, there must be a real plaintiff with a real economic stake, and it is the plaintiff who hires the lawyer, rather than the other way around. The collective action and agency problems that plague other forms of shareholder litigation should thus be largely absent from appraisal. In particular, effective monitoring from a genuine plaintiff with a meaningful stake in the recovery means that the collusive settlements between a defendant corporation and the plaintiff's attorney that are such a danger in representative shareholder litigation will generally be impossible in appraisal.[191]

At the same time the lack of a class appraisal proceeding reduces the agency problem between the plaintiff and her attorney, it also greatly reduces the risk to defendants of catastrophic liability. Class proceedings unavoidably carry with them substantial *in terrorem* value due to the chance—however small—that a finding of liability will result in extremely large liability to a class of all shareholders.[192] In appraisal, the potential liability is limited by the size of the petitioner's holdings. As a result, even a large per share recovery is unlikely to be crippling for an acquirer.

The other unusual features of appraisal also work to reduce the nuisance value of a claim and increase the chance that a decision to seek appraisal will be driven by the merits. Claims tend to have high nuisance value when defendants are risk averse and when the risks and costs of litigating the claim are strongly asymmetric.[193] The litigation risk faced by the parties in appraisal is far more

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> their willingness to undertake a matter—is directly linked to the number of shares in the plaintiff class. In appraisal proceedings, the class tends to be small. In contrast, the representative nature of a class action does not require any action by individual shareholders, except for those shareholders desiring to "opt out" of the class. Ease of formation, coupled with a lack of financial concerns, tends to make the plaintiff group in class actions relatively large. The allocation of attorneys' fees as a percentage of the recovery of the class, when the process is skewed toward creating a large class, may be the pivotal reason for the preference for class actions.

Mary Siegel, *Back to the Future: Appraisal Rights in the Twenty-First Century*, 32 HARV. J. ON LEGIS. 79, 103–04 (1995) (footnotes omitted).

[191] Adding to this dynamic is the fact that Delaware's appraisal statute does not provide for allocating plaintiffs' attorney's fees to the defendant. *See, e.g.*, Cede & Co. v. Technicolor, Inc., 684 A.2d 289, 301 (Del. 1996) ("In the absence of an equitable exception, the plaintiff in an appraisal proceeding should bear the burden of paying its own expert witnesses and attorneys."); Pinson v. Campbell-Taggart, Inc., No. 7499, 1989 WL 17438, at *1109 (Del. Ch. Nov. 28, 1989) ("By its own terms the [appraisal] statute does not authorize the [c]ourt to tax a petitioning stockholder's attorneys' fees and other litigation expenses against the surviving corporation. Those expenses are recoverable only by a *pro rata* apportionment against the value of the shares entitled to an appraisal." (citing DEL. CODE ANN. tit. 8, § 262(j) (2013))); *see also* Siegel, *supra* note 11, at 241 (noting that Delaware's appraisal statute "makes no mention of judicial discretion to allocate one party's expert and attorney expenses to its opponent"). As a result, the only way for a petitioner's attorney to secure payment is through the actual petitioner.

[192] *See supra* Part III.A.

[193] *See* Alexander, *supra* note 1, at 502 n.10 (noting that "high litigation costs and uncertainty about trial outcomes can lead to the settlement of frivolous suits"); Bebchuk,

symmetric than in other forms of merger litigation. The petitioner in an appraisal action faces genuine costs and risks as well. The upfront costs in time and money of simply preserving the ability to seek appraisal will often be substantial.[194]

Perhaps more significantly, the petitioner must forego the merger consideration in order to pursue appraisal. The merger consideration is thus not available for financing the litigation itself, and petitioners "may receive no return on their investment for prolonged periods of time."[195] Furthermore, courts in Delaware do not treat the merger price as a floor for "fair value" in an appraisal valuation.[196] The petitioner in an appraisal action faces a serious risk that the court may in the end determine fair value to be *less* than the merger price, leaving the petitioner worse off than if she had simply taken the merger

supra note 10, at 448; Coffee, Jr., *supra* note 10, at 230–31; Fisch, *supra* note 10, at 546; Rosenberg & Shavell, *supra* note 10, at 9–10.

[194] The literature on appraisal frequently emphasizes the complexity and expense of bringing an appraisal claim. *See, e.g.*, ROBERT CHARLES CLARK, CORPORATE LAW 508 (1986) ("[A]ppraisal is often a cumbersome remedy."); PETER V. LETSOU, CASES AND MATERIALS ON CORPORATE MERGERS AND ACQUISITIONS 429 (2006) (noting that shareholders must navigate a "complicated maze . . . to successfully assert appraisal rights"); Fried & Ganor, *supra* note 15, at 1004 (asserting that "[a]ppraisal litigation is complicated and expensive" and that "many shareholders find it difficult to meet the complicated procedural requirements and deadlines of the appraisal remedy").

[195] Siegel, *supra* note 190, at 103. Randall Thomas examined appraisal actions filed between 1977 and 1997 and reported that the average time from the filing of an appraisal action to the completion was approximately two years. Randall S. Thomas, *Revising the Delaware Appraisal Statute*, 3 DEL. L. REV. 1, 22 (2000). Petitioners are, however, awarded an interest rate on any amounts they receive in a judgment. Our analysis of data from reported opinions reveals that, in the seventeen cases where judges specified the interest rate, they awarded interest of, on average, 7.9%, and it was compounded quarterly or monthly. Appraisal petitioners thus can anticipate being compensated for the duration of an appraisal proceeding. The Delaware legislature recently amended the appraisal statute to provide for a floating rate of interest equal to 5% above the federal funds rate. *See* DEL. CODE ANN. tit. 8, § 262(h) (2013). On the one hand, in an era of historically low interest rates, this may represent an attractive option for shareholders. On the other hand, it may not fully compensate plaintiffs for the opportunity costs of their capital by replicating the return that a shareholder could have achieved by investing the merger proceeds in some portfolio of similarly risky securities. In particular, there is at least some risk that the respondent will go bankrupt, making recovery impossible.

[196] *See, e.g.*, Aspen Advisors LLC v. United Artists Theatre Co., 861 A.2d 1251, 1262 (Del. 2004) (noting that appraisal petitioners can receive "a possibly higher (or possibly lower) 'fair value' award"); Del. Open MRI Radiology Assocs., P.A. v. Kessler, 898 A.2d 290, 310 (Del. Ch. 2006) (noting that the court in an appraisal action "must determine the fair value . . . regardless of whether that amount is greater or less than the merger price"); Gilliland v. Motorola, Inc., 873 A.2d 305, 312 (Del. Ch. 2005) (noting that "a minority stockholder faces the prospect of receiving less than the merger price in the appraisal action"); Union Ill. 1995 Inv. Ltd. P'ship v. Union Fin. Grp., Ltd., 847 A.2d 340, 356 (Del. Ch. 2004) ("In this case, . . . the fair value standard operates to leave the . . . petitioners[] with less than they would have received had they accepted the [m]erger consideration.").

price.[197] This risk stands in contrast to fiduciary duty class actions, where the plaintiffs have usually already received the merger consideration and face no financial downside.[198] In short, fiduciary litigation presents shareholders with costless option value that is lacking in appraisal actions.

The single-issue nature of appraisal also serves to reduce the possibility of nuisance suits. The only issue at stake is the fair value of the petitioner's shares, and the sole remedy available is cash. As a result, there is no possibility of the kind of collusive "disclosure only" settlement that is so prevalent in fiduciary duty class actions, whereby the defendants agree to provide additional disclosure of dubious value to shareholders while providing substantial fees for the plaintiffs' attorneys.[199] In appraisal, a claim settles either for cash or not at all. In addition, the possibility of an injunction or rescission in a fiduciary duty class action—even where it is not truly what the plaintiff wants—may provide settlement leverage that is absent from appraisal, where such remedies are not available.[200]

The narrow focus of the merits issue in appraisal also reduces asymmetry in litigation costs. While litigating fair value is hardly cost-free, the scope of the proceedings is fairly limited, and discovery is restricted to materials bearing on the value of the firm and the negotiation of the merger price. Petitioners typically will seek production of basic financial and deal information—most of which will have already been gathered during the merger process—and both sides will hire experts to conduct valuations and testify at trial. In fiduciary duty suits, by contrast, the claims involved will often be fact-intensive, involving questions of materiality and scienter that can be used to justify sweeping discovery requests—including, for example, years of e-mails from dozens of executives. The ability to impose these large and asymmetric costs on defendants may result in it being cheaper to simply pay a nuisance settlement than to proceed to trial. The costs of appraisal will tend to be much more symmetric. Furthermore, the lack of a class action mechanism will mean that the petitioner will be unable to spread her costs across a class of all shareholders.

Insurance also plays less of a distorting role in appraisal. In a fiduciary duty class action, director and officer liability insurance (D&O insurance) is typically available to pay all or most of the costs of a settlement. Many insurance policies, however, exclude coverage where a claim proceeds to trial and the

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197 Siegel, *supra* note 190, at 103 ("[S]hareholders in appraisal actions risk the possibility of receiving less than the transaction price."). In our examination of appraisal opinions, five of the forty opinions (12.5%) gave the appraisal petitioners a lower price than they would have received in the merger. The lowest gave the petitioner an award that was 19.8% lower than the merger price.

198 *Id.*

199 *See supra* Part II.A.

200 *See* Siegel, *supra* note 190, at 104 ("The ability to seek an injunction or rescissory damages significantly strengthens the minority's bargaining power. As a result, plaintiffs are drawn to class actions to air a broader range of grievances." (footnote omitted)).

defendants are ultimately found culpable.[201] Such policies give defendants a powerful incentive to settle claims before trial, rather than face even a small chance of ending up personally liable for damages. In appraisal, the recovery simply comes from the acquirer, and issues of culpability and personal liability are not involved.

The net result is a situation—unique in shareholder litigation—where the plaintiffs' attorneys are unable to receive significant fees unless the actual named plaintiff receives a substantial monetary recovery. The parties could of course provide for attorney's fees in a settlement agreement, but that fee would be coming directly out of the petitioner's recovery and, in theory, the petitioner can monitor that agency relationship very closely. In sum, the structure of appraisal makes it far more likely than for other forms of merger litigation that the merits will play an important role in the decision to litigate. The agency problem is absent or much reduced, and the parties are faced with far more symmetrical risks and costs in the proceeding.

This is not to suggest that abusive appraisal litigation is not possible or that a stockholder will never find it profitable to file a "nuisance" petition. Fending off a meritless appraisal claim would not be costless, and an acquirer may be tempted to simply pay the petitioner enough to go away. There are no grounds on which to dismiss an appraisal petition before trial, and from a defendant's perspective, the litigation costs of defending an appraisal case are the same whether the petitioner holds one share or one million. Thus, the plaintiff's attorney might find a small holder and threaten to put the defendant through the costs of defending the claim. Defendants may wish to avoid those costs and swiftly resolve litigation involving the merger, and as a result defendants may settle appraisal claims with small holders for nuisance value.

Such a possibility, however, is inherent in any form of litigation. There would be little to distinguish appraisal in this regard from a meritless contract claim, defamation claim, "slip-and-fall" claim, or any other type of potentially-vexatious claim. To the extent, then, that other forms of merger claims display less merit than appraisal claims, we can be confident that the low merit of the merger claims stems from the particular features of aggregate shareholder litigation, rather than from the risk of nuisance claims inherent in any form of litigation. To the extent that agency costs and other particular structural features are driving the pathologies of shareholder litigation, we would expect these pathologies to be much reduced in appraisal litigation.

IV. EMPIRICAL INVESTIGATION OF MERGER CLASS ACTION LITIGATION AGAINST DELAWARE FIRMS

We are now in a position to investigate whether the merits matter in fiduciary class actions. As discussed above,[202] in asking whether the merits

[201] *See supra* note 37.
[202] *See supra* Part III.

matter, the real question is how mergers are selected for litigation. Are plaintiffs targeting deals where there is reason to believe the merger consideration was inadequate? Or are they simply seeking defendants with deep pockets who may be willing to settle for nuisance value?

If this dynamic is at work in merger litigation, we would expect to find that large transactions are disproportionately targeted for suit and also that the adequacy of the merger price has little or no predictive power.[203] To test these propositions, we compiled a set of transactions from the Thomson One database of merger transactions with Delaware-incorporated, public company targets that closed between 2004 and 2013. To be able to perform a direct comparison of transactions attracting fiduciary duty class actions and transactions attracting appraisal petitions, we restricted our sample of transactions to those where appraisal was available. For this universe of transactions, we collected data on the incidence of merger class action litigation and on the incidence of appraisal litigation.[204] This allows us to compare the selection of merger transactions for challenge via different types of shareholder litigation.

Consistent with conventional wisdom, fiduciary duty class actions were substantially more common than appraisal. Out of 1,168 appraisal-eligible transactions for which litigation data was available, 683 attracted at least one fiduciary class action. By contrast, only eighty-seven transactions involved a counseled appraisal petition, with an additional seven transactions attracting only *pro se* petitions.[205] Table 1 presents the general pattern of litigation.

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[203] There may be some reason to expect larger deals to attract more appraisal action, in that a larger corporation is likely to have more minority shareholders with a large enough stake to potentially justify the costs of an appraisal action. Nonetheless, we would expect the size of the merger premium to be the most predictive single variable.

[204] BALOTTI & FINKELSTEIN, *supra* note 140, § 9.30 (Supp. 2009) (noting that a shareholder opposing a merger "can seek judicial relief from the merger, generally by attacking the fairness of the merger or asserting his right to an appraisal where one exists").

[205] While we will occasionally discuss *pro se* appraisal petitions, for the most part the discussion will focus on counseled appraisal petitioners. This is both because counseled petitioners are far more economically significant and because we are interested in assessing the role of the lawyer and agency costs in the selection of disputes for litigation. Whatever factors might determine when a *pro se* claimant files suit, an agency problem with counsel cannot be among them.

Table 1: *Incidence of Fiduciary Claims and Appraisal Claims*

<table>
<tr><td colspan="2" rowspan="2"></td><td colspan="3">Fiduciary Class Action</td></tr>
<tr><td>No</td><td>Yes</td><td>Total</td></tr>
<tr><td rowspan="3">Appraisal (Counseled)</td><td>No</td><td>470</td><td>611</td><td>1,081</td></tr>
<tr><td>Yes</td><td>15</td><td>72</td><td>87</td></tr>
<tr><td>Total</td><td>485</td><td>683</td><td>1,168</td></tr>
</table>

In evaluating how disputes were selected for either type of litigation, we examine two principal metrics. The first represents the size of the transaction, which should be only weakly correlated to the merits but which will correspond strongly with the nuisance value of the claim.[206] The second represents the adequacy of the merger consideration, which we believe should be strongly relevant to the merits.[207] We consider these two metrics below. All else being equal, a large merger premium should suggest a strong merger claim and a small merger premium should suggest a weak merger claim. By contrast, we would expect there to be only a weak relationship between the sheer size of the transaction and the merit of a claim.[208] We consider these two metrics below.

In this Part, we examine transactions where stockholders pressed fiduciary duty class actions, and in the next Part we perform a similar analysis for appraisal.

A. *The Importance of Transaction Size*

Over half of the transactions in our dataset of appraisal-eligible mergers (683 out of 1,168) attracted at least one fiduciary suit, and many transactions attracted multiple suits. To examine the effect of deal size on the likelihood of litigation, we used two measures of the value of the transaction: (i) "enterprise value" (the total merger consideration); and (ii) "equity value" (the amount of merger consideration allocated to the shareholders). Both are calculated in constant 2013 dollars.

The transactions shareholders selected for fiduciary suits were significantly larger than other transactions by both measures of transaction size. Table 2 presents mean and median transaction sizes for the transactions that attracted no

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[206] *See infra* Part IV.A.

[207] *See infra* Part IV.B.

[208] As is discussed below, there might be some innocent reasons to think shareholders will disproportionately target large transactions and deep pockets. Plaintiffs' attorneys need some assurance that the potential recovery will be sufficient to cover the fixed costs of litigating the claim. In short, deep pockets may be a necessary, but not sufficient, criterion for bringing a claim. *See infra* Part IV.D.

fiduciary suits, those that attracted at least one suit, and the 128 transactions that attracted six or more suits.[209]

Table 2: *Comparison of Transaction Size in Fiduciary Cases, in Millions of 2013 Dollars*

	Equity Value		Enterprise Value	
	Mean	Median	Mean	Median
No Fiduciary Suit	$1,320	$245	$2,146	$265
At Least One	2,466	644	3,107	748
Six or More	5,519	1,523	6,592	1,571

The differences between nearly all of these groups are statistically significant beyond all conventional levels.[210] The strong relationship between transaction size and the incidence of fiduciary suits can be seen visually. The difference is clearly visible in Figure 1, which shows kernel density plots[211] of the log equity value of transactions attracting fiduciary litigation (in gray) and those not attracting such litigation (in black).

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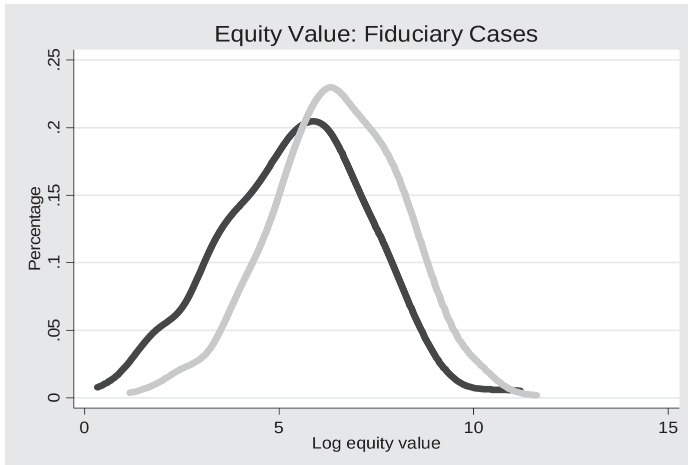
[209] Among all transactions, six was the 90th percentile in the number of fiduciary suits.

[210] The p-values of two-sided t-tests between any two groups (measured in log dollars or raw dollars) is always smaller than 0.002, except for the difference between raw enterprise value for sued and un-sued transactions, where the p-value is 0.128.

[211] A kernel density plot is a form of smoothed histogram that allows the estimation of the shape of an underlying function from a finite number of discrete observations. *See generally* B. W. SILVERMAN, DENSITY ESTIMATION FOR STATISTICS AND DATA ANALYSIS 58 (1988).

Figure 1: *Value for Transactions with Fiduciary Litigation (Gray)*



As Table 2 and Figure 1 reveal, fiduciary suits target large deals.[212] High levels of fiduciary litigation activity, with six or more suits filed, are associated with especially large deal sizes—more than four times the mean for deals with no fiduciary suits (equity value of $5.5B vs. $1.3B). The first major empirical result, then, is that merger litigation is disproportionately targeted towards larger deals and deeper pockets, and the larger the deal the more intense the litigation activity.

B. *The Unimportance of the Merger Premium*

Our metric of merit is the merger premium. The adequacy of the premium should correlate both to the likelihood of fiduciary failure and to the magnitude of the damages in the event of liability. Other "merits-related" issues, such as procedural or disclosure shortcomings in the merger process, are likely to be of concern to shareholders only insofar as they lead to inadequate merger consideration. Thus, if the merits matter, so should the size of the merger premium, which is directly observable.

The measure of merger premium that is relevant for fiduciary plaintiffs is the initial premium offered to shareholders. The price at the announcement of the transaction is the one that plaintiffs' attorneys must evaluate when deciding whether to challenge the transaction. The raw size of the merger premium for any given deal is, however, not a particularly satisfactory measure of the adequacy of the merger consideration (and, thus, the merits of the claim). This is so because average merger premia vary widely across industries and across time, with average premia being much higher, for example, in 2007—in the hot deal market before the onset of the financial crisis—than in 2009, during the

[212] A plot using enterprise value rather than equity value looks virtually identical.

cold deal market in the immediate aftermath of the crisis. Furthermore, as we might expect, larger deals tend to involve smaller premia as measured in percentage terms. In order to serve as a more accurate proxy for merit, we need a measure of the adequacy of the merger premium, as compared to some "expected" premium given the characteristics of the deal.

To achieve this, we computed an "expected" merger premium based on the most salient variables: the size of the target company,[213] the year of the transaction, and the target company's industry. We then used the residual premium—the difference between the expected premium and the actual premium—as our proxy for the merits of the underlying legal claim.[214] Thus, a positive residual indicates that the actual merger premium was greater than the expected merger premium. Meanwhile, a negative residual indicates that the actual merger premium was less than the expected merger premium and thus, all else being equal, more likely to be inadequate. For both fiduciary and appraisal actions, we would expect that the size of the residual premium should be negatively correlated with the merits of a claim—a positive residual premium implies a less meritorious claim, while a large negative residual premium ought to suggest a stronger claim, all else being equal.

In contrast to transaction size, we find that the deal premium appears to play little role in the incidence of fiduciary litigation. We calculated a residual premium based on three measures of actual premium: the one-day premium, the one-week premium, and the four-week premium. Table 3 shows the mean and median deal premia residuals for transactions with no fiduciary litigation, those with at least one suit, and those with six or more.

[213] In order to avoid circularity, we use the market value of the target company four weeks prior to the merger announcement as the measure of the target's size. By using this measure, we avoid the problem of having the target company's market value be distorted by the proposed terms of the merger.

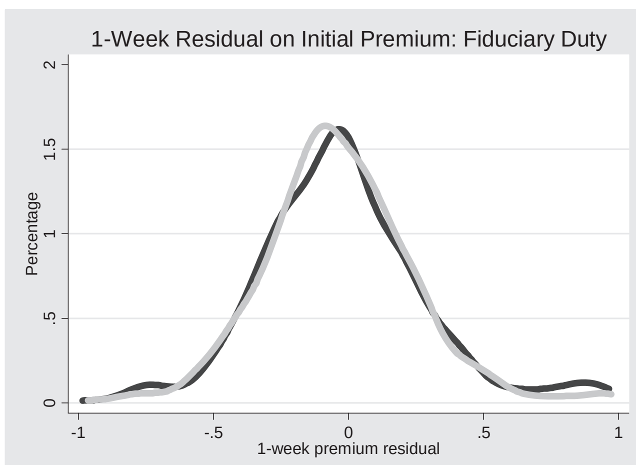
[214] The procedure used here is similar to that employed by Morley and Curtis in their analysis of excessive fee litigation targeting mutual funds. *See* Curtis & Morley, *supra* note 2, at 286. Rather than simply using the raw size of the fee charged by the relevant mutual fund as their measure of merit for excessive fee litigation, they first calculate an average fee for funds with a similar investment style, and then subtract that average from the individual fund's actual fee. *Id.* The result is what they call the "style-demeaned expense ratio." *Id.*

Table 3: *Comparison of Merger Premia Residuals in Fiduciary Cases*

	1-Day Premium		1-Week Premium		4-Week Premium	
	Mean	Median	Mean	Median	Mean	Median
No Fiduciary Suit	2.7%	-3.5%	4.0%	-3.4%	4.2%	-2.8%
At least one	-1.5	-5.0	-1.5	-5.2	-1.9	-5.1
Six or more	0.8	-0.8	0.2	-0.2	2.1	-2.4

Transactions targeted by fiduciary suits have lower deal residuals than non-targeted transactions, though the intense litigation activity does not appear to be associated with lower premia. Furthermore, none of these differences in residuals are statistically significant at any conventional levels. Figure 2 illustrates the strong similarity in one-week premia between those transactions that attracted fiduciary litigation (in gray) and those that did not (in black).[215]

Figure 2: *One-Week Initial Premium Residuals for Transactions with Fiduciary Litigation (Gray) and Without (Black)*



Transactions attracting fiduciary litigation do not appear to have premia that are statistically distinguishable from those not attracting fiduciary litigation. To the extent deal premia measure the merit of fiduciary litigation, the transactions that were sued were not stronger legal claims than the un-sued transactions.

[215] The plots for residuals on the one-day premium and the one-week premium are similar.

C. *Empirical Analysis of the Incidence of Fiduciary Suits*

We use regression analysis to further investigate what drives the selection of transactions for fiduciary litigation. The most basic question is what factors are associated with the filing of a fiduciary suit against a transaction, and we investigate this question with a logistic regression model. Our dependent variable is a dummy that we assign a value of one if the transaction faced one or more fiduciary class actions and zero otherwise. As independent variables we used the size of the transaction, the residual premium, and variables indicating a going-private transaction or a financial buyer.[216] We present our results in Panel A of the Appendix. Regardless of what variables we use in our regression, the coefficients on transaction size—whether measured in equity value or enterprise value—are positive and statistically significant beyond the 1% level. The coefficient on the deal premium's residual variable is negative and consistently significant. Across all specifications, the coefficients on our variables of interest are relatively similar, suggesting that our results are robust. The presence of a financial buyer like a private equity fund is also positive and strongly significant. These results suggest that the merits do matter to at least some extent.

To get a sense of the relative magnitude of the effects that these variables have on the incidence of a fiduciary suit, we calculated the marginal effects at the mean. In Model 3, for example, a one standard deviation increase in the size of the transaction increases the likelihood of a fiduciary suit by 16.9%.[217] A one standard decrease in the one-week premium residual produces a 6% increase in the likelihood of a fiduciary suit.[218] The presence of a financial buyer is associated with a 20% increase in the probability of suit.[219]

We also ran a logistic regression where our dependent variable takes the value 1 if the transaction attracted six or more fiduciary suits using the same independent variables. These results appear in Panel B of the Appendix. These results show a highly significant effect for both measures of transaction size but no statistically significant effect for any measure of deal premium residual. The going-private variable is significant at the 10% level and the coefficient is positive, as is the presence of a financial buyer.

To look beyond the simple yes-or-no question of whether a fiduciary class action was filed, we examine the *intensity* of litigation activity. Among the transactions that are sued, litigation activity varies. The mean number of suits filed was 2.2 and the standard deviation was 3.2. Of the 683 sued transactions, approximately half attracted only one or two filings, while forty-four transactions resulted in ten or more complaints being filed. We can thus look at

[216] These last two variables are dummy variables that take a value of one if the deal has that characteristic (i.e., a financial buyer) and zero if it does not.

[217] The 95% confidence interval is between 13.4% and 20.4%.

[218] The confidence interval spans from a 0.6% to an 11.2% increase.

[219] The confidence interval spans from a 13.5% increase to a 27%.

the number of fiduciary complaints that a transaction provokes, treating this number as a proxy for the intensity of plaintiffs' attorney interest in a deal.

To investigate what factors induced greater litigation activity, we ran a Poisson regression where our dependent variable was the number of fiduciary complaints filed. We used the same independent variables relied on in our logistic regressions above. Our results are reported in Panel C of the Appendix. In all specifications, we obtain estimates of all coefficients that are statistically significant beyond the 1% level. The coefficient for our size variables is always positive, and the coefficients for our premium residual variables are always negative.

As with the logistic regression, we can estimate the magnitude of these effects,[220] and these are consistent with the results of the logistic regression. Transaction size has a much larger effect on the incidence of fiduciary litigation than the premium residual. In our Poisson regression, a one standard deviation change in transaction size from the mean implies 1.1 additional fiduciary class action suits.[221] With deal premium, a decrease of one standard deviation from the mean implies 0.4 additional suits.

D. *Interpreting Our Results*

While both deal size and deal premium appear to be relevant, the variable with the strongest effect on the incidence and intensity of fiduciary litigation is transaction size, dwarfing in magnitude the effect of deal premium. Given that transaction size has a substantially weaker relationship to legal merit, we conclude that fiduciary litigation is largely driven by non-merits factors. We are nevertheless sensitive to two potential counter-arguments: (i) that class action plaintiffs might disproportionately target large deals even if the merits do matter; and (ii) that the size of the merger premium is not necessarily relevant to the merits. We address these arguments in turn.

In our analysis, we assume that the size of the transaction should not be strongly correlated with the merits, and thus it should not be the key factor in deciding to bring suit. It is this assumption that allows us to infer that plaintiffs' attorneys are seeking deep pockets and high nuisance value rather than meritorious claims. This is, however, not the only interpretation possible. Even if the merits did matter, we might expect plaintiffs' attorneys disproportionately to target large deals, where the potential damages are large enough to make the claim worthwhile. Phrased differently, perhaps a large potential recovery is a necessary condition for bringing even a meritorious claim—perhaps large, meritorious claims are the only kind worth bringing.[222]

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[220] For the sake of consistency, we again use Model 3 to generate our estimates.

[221] The 95% confidence interval is 1.0 and 1.2 additional suits.

[222] *See supra* Part IV.B; *see also* Choi, *supra* note 2, at 1480–81 ("Plaintiffs' attorneys [would] not wish to file even a meritorious suit against a small market capitalization firm . . . to the extent the potential damages from such a suit are low and thus unlikely to compensate the plaintiffs' attorney[s] for the relatively fixed costs of litigation."); *Id.* at 1489

We regard it as unlikely that this is the dynamic driving our results. The potential (non-nuisance) value of a claim should be the product of three major variables: (i) the probability of prevailing at trial; (ii) the amount (in percentage terms) by which the merger price was too low; and (iii) the size of the transaction.[223] At most, the size of the transaction should be *as* important as the inadequacy of the merger price. More likely, it is substantially less important. If small transactions are more likely to involve lower-quality lawyers and bankers, and a correspondingly higher chance of the types of procedural deficiencies that could lead to liability, this should cut against the importance of deal size.[224] Furthermore, to the extent that factors (i) and (ii) are correlated (i.e. particularly egregious breaches of duty lead to particularly low merger prices), the inadequacy of the merger price should be more important than the deal size. This is not what we observe. Instead, we observe that the deal size matters a great deal, overshadowing the inadequacy of the merger price.

Similarly, it might be argued that the residual merger premium is not an adequate proxy for the merits of a fiduciary duty class action. After all, actually showing liability in such claims will generally turn on the ability to show a breach of fiduciary duty, rather than simply showing that the price was too low.[225] This criticism, however, misses the mark.[226] As noted above, even if the inadequacy of the merger premium was wholly uncorrelated with the ability to show breach of duty, it would still be relevant to potential damages at trial. Again, at the very least, even if the inadequacy of the merger consideration is wholly uncorrelated to the chances of success on the merits, it should still be as important as the deal size in determining whether to bring suit. Instead, we find that the premium has a much smaller effect on the decision to sue.

Furthermore, it strikes us as implausible that the residual merger premium is uncorrelated to the chances of success on the merits. Much of the logic of imposing *Revlon* duties or similar requirements is that the failure to do so could lead to a failure to maximize shareholder value. This is, in part, why the residual

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("[M]arket capitalization, volatility, equity beta, and share turnover [] may represent necessary but not sufficient factors for both frivolous and meritorious litigation.").

[223] *See supra* Part III.

[224] *See, e.g.*, U.S. SEC. & EXCH. COMM'N, FINAL REPORT OF THE ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES TO THE UNITED STATES SECURITIES & EXCHANGE COMMISSION 139 (2006), *available at* www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf (noting that "small firms consistently have more misstatements and restatements of financial information, nearly twice the rate of large firms")

[225] *See In re* Trados Inc. S'holder Litig., 73 A.3d 17, 35 (Del. Ch. 2013) ("[A] breach of fiduciary duty claim seeks an equitable remedy that requires a finding of wrongdoing. The appraisal proceeding seeks a statutory determination of fair value that does not require a finding of wrongdoing."). For a dramatic example of the fact that these two questions are not always equivalent, compare *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1176–77 (Del. 1995) (affirming a determination that a merger price of $23 per share was entirely fair), with *Cede & Co. v. Technicolor, Inc.*, 884 A.2d 26, 30 (Del. 2005) (awarding fair value in appraisal of $28.41 per share for the same transaction).

[226] *See supra* Part IV.C.

merger premium makes a superior proxy for the merits than others used previously for securities fraud cases, such as volatility and share turnover.[227] While such measures are (like the residual merger premium) correlated to the potential damages on the merits, they (unlike the residual merger premium) lack any close correlation to the presence of culpable conduct. In addition, even the correlation to the potential damages on the merits is weaker for these other proxies, in that in other forms of shareholder litigation the possibility exists that non-monetary remedies—such as governance reforms—may carry meaningful value. By contrast, in merger litigation—an end-period transaction for the shareholders—monetary damages are the only meaningful remedy.

E. *Do the Merits Matter in Other Ways?*

We have thus far ignored a different and important way that merit might potentially affect fiduciary class actions: the *outcome* of fiduciary class actions may be merits related, even if the decision to bring an action is not. Thus, another way of evaluating the merit of fiduciary suits in the merger context is to examine the relationship between suits and increases in transaction price. It would be bizarre, of course, to discover that the merits did not matter in filing claims but did matter in the outcome of the claims. If outcomes showed any consistent relationship to the merits, it would be more than a little strange for plaintiffs' attorneys to ignore the merits in deciding whether to bring suit. Instead, we would expect them to disproportionately target transactions where a highly positive outcome is expected. Nonetheless, the possibility is worth exploring.

In the preceding analysis, we relied on the initial merger price as our estimate of merit and use that variable in our regressions to predict the incidence of litigation. Given that changes in the merger price can occur after the filing of lawsuits, we can ask the natural next question: is the incidence of a fiduciary suit associated with an increase in merger price? A merger price might increase for a variety of reasons: a topping bid from a new suitor, a concerted pressure campaign by activist shareholders, or the defeat of the transaction by shareholders and a subsequent price increase to attract more votes. And of course the merger price might increase as a direct or indirect result of fiduciary litigation.[228] We are relatively indifferent as to the cause of the increase and ask only the threshold question of whether plaintiffs' attorneys target transactions where the merger price ultimately increases. Either explanation would be sufficient to demonstrate that plaintiffs' attorneys take some estimate of merit into account in targeting transactions: either that they can cause the price to go up or they can predict where someone else will think the company is

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227 *See supra* Part IV.B.

228 As others have shown, the vast majority of cases result in a "disclosure only" settlement and with no tangible recovery at all for shareholders. *See* Cain & Davidoff, *supra* note 9, at 35 (reporting that approximately 80% of the fiduciary duty class actions in 2010 ended in disclosure only settlements).

underpriced and cause the price go up (perhaps enabling the attorneys to claim some credit for the increase).

In fact, the final merger consideration for transactions that were sued increased by 2.5% on average, and for un-sued transactions the mean increase was 2.1%. This difference, however, is not statistically significant.[229] We ran an ordinary least squares (OLS) regression to investigate the connection further where our dependent variable was the increase in merger price, and our independent variables were the size of the transaction, the presence of a fiduciary suit, the number of fiduciary lawsuits, a going-private variable, and a financial buyer variable.

Panel D in the Appendix reports our results. Our results show that fiduciary suits have no measurable effect on increases in the merger consideration. While the coefficients are positive—indicating that fiduciary suits correlate with a larger increase in merger consideration—neither the incidence nor the intensity of the suit has a statistically significant coefficient. The only variables that are strongly associated with a change in the transaction price are the going private dummy variable and the financial buyer dummy variable. The sign on the coefficient for the going private dummy variable is positive, suggesting that controlling shareholders are often forced to raise their bids. The sign on the financial buyer variable is negative, suggesting that financial buyers are not associated with topping bids, perhaps because they are often involved in auctions that induce the best possible bid or perhaps because they insist on deal protections like termination fees that inhibit additional bidding.

Taken together, our empirical results suggest that fiduciary class actions targeted large transactions and deal price is not as important to fiduciary plaintiffs. We also find that the incidence of fiduciary class actions is not associated with significant increases in the merger consideration. In other words, there is very little evidence that fiduciary suits are associated with merit.

V. DO THE MERITS MATTER IN APPRAISAL LITIGATION?

The results presented above already suggest that in the merger context, the merits are not the principal driver of fiduciary duty litigation, if they matter at all. By comparing the analysis above with a similar analysis for appraisal litigation involving the same universe of transactions, however, we strengthen the result in two ways. First, we provide a vivid contrast, enabling us to see the extent to which the pattern of fiduciary duty litigation departs from the pattern that prevails in merit-driven litigation. Second, we begin to narrow down the potential causes for the dysfunction prevailing in shareholder litigation. If, despite their structural differences, patterns of litigation were similar for fiduciary duty claims and appraisal, we might be forced to conclude that the irrelevance of the merits in shareholder litigation is simply an unavoidable phenomenon and no different than in any other type of litigation. Because, as

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[229] The p-value in a two-sided t-test is 0.65.

we show, the patterns of litigation are in fact starkly different, we infer that the particular structural features of shareholder litigation are to blame for its peculiarly vexatious character.

A. *Descriptive Statistics for Appraisal*

We perform the same battery of statistical tests on appraisal litigation that we performed on fiduciary duty litigation. But before doing so, it is worth examining the practice of appraisal litigation descriptively in order to validate our hypothesis that appraisal claims should tend to be meritorious.[230] We collected all appraisal petitions filed in the Delaware Court of Chancery since that court moved to electronic dockets in 2003. We identified 139 appraisal petitions involving transactions between 2004 and 2013 where the target was a publicly-traded company. These petitions targeted 108 separate transactions. Of these, only ninety-five target companies appear in our data on 1,168 appraisal-eligible merger transactions during the same period. One of these transactions involved a dispute only over preferred stock, leaving ninety-four appraisal disputes involving public company common stock.

On the incidence of appraisal, the common scholarly perception is that stockholders rarely invoke the remedy.[231] The raw numbers offer some support to this view, in that the frequency of appraisal petitions is substantially less than that of fiduciary duty class actions. Only 8% of eligible transactions between

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[230] In addition to providing this robustness check for our intuitions, simply providing a fuller perspective on appraisal activity is itself valuable, as the literature betrays a dearth of information on the overall incidence of appraisal litigation. Indeed, there is very little existing empirical work on appraisal litigation. Randall Thomas collected 266 appraisal actions filed in Delaware from 1977 to 1997. Thomas, *supra* note 195, at 22. Thomas presented figures on the duration of the proceedings, the number of motions the parties filed, and the number of judicial hearings, but did not attempt to assess the merits or outcomes of the claims. *Id.* at 22–23 (reporting an average duration of 727 days and that in all 266 cases there were 572 motions filed and 84 judicial hearings). Feng Chen, Kenton K. Yee, and Yong Keun Yoo claim to have gathered a list of all *opinions* in appraisal actions published in the Lexis-Nexis database over the past several decades. *See* Feng Chen et al., *Robustness of Judicial Decisions to Valuation-Method Innovation: An Exploratory Empirical Study*, 37 J. BUS. FIN. & ACCT. 1094, 1096 (2010). Because the bulk of claims are settled without generating an opinion, however, their study paints only a highly incomplete picture of appraisal litigation as a whole. *See id.* Furthermore, a substantial portion of the cases they examine are not actually statutory appraisal actions; many are other forms of shareholder litigation that happened to require the court to calculate the fair value of the plaintiffs' shares. *See id.*

[231] *See supra* note 182. In an unpublished work, Randall Thomas cataloged appraisal petitions in the Delaware Court of Chancery through 2005, noting variation from a baseline of "relatively few" filings. *See* PowerPoint Presentation by Randall S. Thomas, Vanderbilt Law School, Do We Need to Fix the Delaware Appraisal Statute? (on file with authors).

2004 and 2013 attracted at least one appraisal petition. In absolute terms, however, the number of appraisal actions is hardly trivial.[232]

Another threshold issue is the size of the petitioners' holdings. If the merits matter in appraisal, we would expect petitioners to possess substantial holdings such that the prospective recovery at trial justifies the expense of litigation. Conversely, if appraisal petitions are brought by plaintiffs' attorneys without regard for the merits, largely in order to extract a nuisance settlement, we would expect petitioners to resemble the named plaintiffs in other forms of shareholder litigation, who often own only a handful of shares. After all, it costs the same amount to defend an appraisal claim regardless of how many shares the petitioner owns.[233]

Dissenters had substantial holdings in the target company stock. In order to pursue an appraisal action, the petitioner must turn down the option of receiving the merger consideration. The consideration the petitioner would have received in the merger thus can serve as a rough measure of the size of the petitioner's potential claim. We measure the holdings in two ways—in 2013 dollars and as a percentage of the total equity of the target company—and we can determine these amounts for the dissenting group in eighty-five of the public company mergers with counseled appraisal petitions.[234] While not ideal measures of the expected value of the petitioners' claims, these numbers reveal that the majority of petitioners have a sizeable economic interest in the litigation. The largest dissenting group had $654 million in target company stock as of the merger date and the smallest held $2,262. The mean petitioner group had holdings of $36.6 million, and the median was $1.8 million. In percentage terms, the smallest challenge was by stockholders owning 0.000127% of the equity value, and the largest was 31.3%. The mean was 3.2% and the median was 0.96%. Thus, the median appraisal group represents fairly substantial stockholdings, as opposed to being a professional plaintiff owning a handful of shares. Approximately 86% of our sample has a greater economic stake than what now-Vice Chancellor Laster has suggested as a threshold beyond which an appraisal action is potentially worth filing.[235] With such large amounts at stake, the value of the claim itself should exceed the litigation cost in the majority of cases.

A unique feature of appraisal is that a surprising number of petitions are filed *pro se*, without the assistance of an attorney. Nine of the 139 appraisal

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[232] In addition, our data show a sharp increase in appraisal activity after 2011. We discuss this phenomenon in our companion paper. *See* Korsmo & Myers, *supra* note 18 (manuscript at 14). Nothing in the "new era" of appraisal alters the results or interpretation presented here.

[233] *See infra* Part V.B.

[234] In most cases, there was only one petitioner. In cases with more than one petitioner regarding the same transaction, however, we summed the shares held by all of the petitioners.

[235] *See* J. Travis Laster, *The Appraisal Remedy in Third Party Deals*, 18 INSIGHTS 4 (Apr. 2004) (suggesting a $500,000 threshold). Adjusted to 2013 dollars, that figure is $620,000.

petitions—or 6.5%—were brought *pro se*. This is in contrast to other forms of shareholder litigation, which are almost never brought *pro se*. In one database of over 600 derivative suits over options backdating, for example, there is only one *pro se* case.[236] Whatever demons may drive *pro se* litigation, we can be confident that agency costs are not among them. *Pro se* litigants, acting on their own behalf and bearing their own expenses, must believe that the game is worth the candle, even if that belief is not always reasonable.[237] In fact, even the *pro se* litigants in our sample often have a considerable amount at stake. For public company targets, such *pro se* plaintiffs owned a mean value of $525,000 with a median of $28,935. While these amounts are, unsurprisingly, significantly smaller than those at stake for counseled petitioners,[238] they are large enough to suggest that real value is at stake even in many *pro se* petitions.

The infrequency with which most forms of shareholder litigation go to trial and the almost complete absence of cases where the plaintiffs prevail on the merits are often cited as evidence of a lack of merit.[239] While a large majority of appraisal cases in our dataset also ended in settlement, the rate of trial is far higher than in other forms of shareholder litigation. Approximately 75% of the disputes have been resolved, and of these approximately 80% of the resolved cases were settled. Nine cases—nearly 10% of the overall disputes—were tried to judgment.[240] We cannot observe the settlement amounts in most circumstances because the parties do not make the terms of the settlement public. The trial outcomes, however, are observable, and while they suggest that appraisal petitioners face a considerable amount of risk in their claims,[241] they also reveal a respectable track record of success on the merits. Of the nine trial outcomes, the median award was a 19.5% premium over the merger

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[236] *See generally* Quinn Curtis & Minor Myers, Do the Merits Matter? Evidence from Options Backdating Derivative Litigation (Sept. 1, 2014) (unpublished manuscript) (on file with authors). The relatively high incidence of *pro se* litigation suggests, first, that characterizations of appraisal actions as procedurally Byzantine are off the mark. Mahoney and Weinstein, for example, argue that "it is unlikely that an average shareholder would successfully negotiate the procedural steps required to be entitled to [appraisal] without the advice of a lawyer." Mahoney & Weinstein, *supra* note 16, at 244. Our findings suggest that, if anything, the procedural aspects of an appraisal proceeding may be more straightforward than those associated with derivative litigation.

[237] While it is possible that a *pro se* plaintiff may bring a claim in an attempt to extract a nuisance settlement, we see no evidence of serial *pro se* litigants or other indications of abusive litigation. The profile of a *pro se* appraisal petitioner appears to be simply a disgruntled shareholder who does not want to pay an attorney.

[238] A two-sample t-test in log dollars shows the difference in merger consideration for counseled versus *pro se* plaintiffs is statistically significant at the $p = 0.001$ level.

[239] *See* Romano, *supra* note 1, at 60–61.

[240] Of the remainder, some petitions were withdrawn, others were dismissed without prejudice, and some were dismissed for failure to prosecute. Not surprisingly, cases involving larger dollar amounts tend to go to trial more often than cases involving smaller dollar amounts.

[241] One trial awarded dissenters 19.5% below the merger price, and another trial determined that the dissenters' holdings were completely worthless.

consideration. This success at trial stands in sharp contrast to other forms of shareholder litigation and indicates that appraisal claims that go to trial, at the very least, frequently have merit.

These descriptive statistics show that appraisal actions bear few of the hallmarks of the agency costs that bedevil other forms of shareholder litigation. They also provide some assurance that we are justified in using the characteristics of transactions selected for appraisal litigation as a benchmark for evaluating the merits of fiduciary duty class actions.

B. *The Unimportance of Transaction Size in Appraisal*

To examine the effect of deal size on the likelihood of appraisal, we used the same two measures of the value of the transaction that we used for fiduciary duty class actions: enterprise value and equity value.[242] Again, both are calculated in constant 2013 dollars. Table 4 reports the mean and median sizes of both measures of transaction size across various categories of transactions.

Table 4: *Comparison of Transaction Size in Appraisal Cases, in Millions of 2013 Dollars*

	Equity Value		Enterprise Value	
	Mean	Median	Mean	Median
No Appraisal	$1,912	$458	$2,686	$481
All Appraisal	2,909	465	3,007	536
Pro Se Appraisal	21,042	1,333	20,945	1,292
Counseled Appraisal	1,450	433	1,564	490

Transactions attracting appraisal are slightly larger, on both measures of size, than transactions not attracting appraisal.[243] When we consider only those appraisal actions filed by plaintiffs represented by counsel, however, the difference in deal size disappears. Indeed, transactions attracting counseled appraisal actions are actually *smaller* than the deals that did not generate a counseled appraisal action. It is only *pro se* plaintiffs who disproportionately target the largest deals.[244] Whatever is driving *pro se* plaintiffs to target large deals, we can be certain that it is not agency costs.

[242] It could be argued that the size of the *acquirer* would be a more appropriate metric, as it is the acquirer who will pay any judgment or settlement and thus would represent the potential "deep pocket." For reasons discussed below, it is neither possible nor necessary to examine acquirer size.

[243] None of the differences in transaction size (measured in raw or log dollars) between transactions attracting appraisal and those that do not is significant at any conventional level.

[244] Across both measures of size and also when looking at log dollars, the difference in transaction size between transactions with counseled petitions and *pro se* petitions is significant at least at the 5% level.

For counseled petitions, the difference in transaction size between deals that attracted appraisal petitions and those that did not is not statistically significant, whether measured in constant dollars or in the logarithm of constant dollars. This lack of a strong relationship between transaction size and counseled appraisal can be seen visually. Figure 3 shows a kernel density plot of transactions that attracted counseled appraisal petitions in gray and those transactions that did not in black.

Figure 3: *Density Plot of Transactions Attracting Counseled Appraisal Petition (Gray), by the Logarithm of Equity Size*

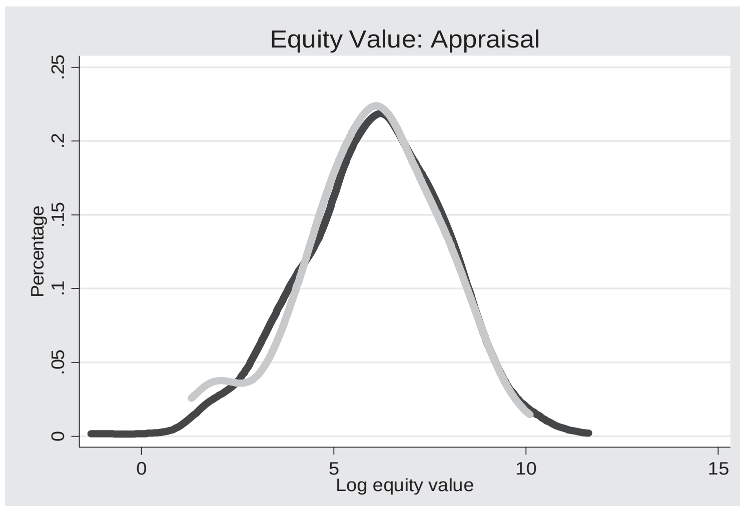

Figure 3 illustrates that those transactions that attracted counseled appraisal petitions differ only slightly, if at all, in equity value from those that did not. A plot using enterprise value rather than equity value looks similar.

A potential criticism of our analysis here is that we are not comparing apples to apples when we look at the size of the transaction for both fiduciary duty class actions and for appraisal actions. After all, while in a fiduciary duty class action it is the *target* company's officers and directors being sued, in an appraisal action any resulting damage award is a liability of the *acquiring* company. If appraisal petitioners are seeking deep pockets for nuisance claims, then, we might want to look at the size of the acquirer instead of the size of the target.

We are not able to construct any reliable tests that get at whether acquirer size matters. More than half of the acquirers in our sample (617 out of 1,168) are not publicly traded. These include foreign firms, private companies, and investment vehicles like private equity funds, for which we have no reliable information on their size. For the limited universe of transactions where we have information on the acquirer's market value, we find no statistically significant difference between transactions attracting appraisal and those that do not.[245]

Moreover, there are strong reasons to suspect that the set of transactions with public acquirers is not representative of the larger universe of appraisal-eligible transactions. Many, if not most, acquisitions with a publicly traded acquirer involve substantial synergies—one competitor buying another, for example—and synergies are excluded from the calculation of the value of an appraisal petitioner's shares.[246] This increases the possibility that the court will find fair value—net of synergies—to be below the merger price. By contrast, many non-publicly traded acquirers are financial buyers, where synergistic gains are likely to be small or non-existent. Looking only at deals with publicly-traded buyers would thus involve a skewed sample where the risks of appraisal are likely to be abnormally high.

Relying on transaction size is unlikely to be a particularly serious problem. Deal size is not a perfect proxy for deep pockets in an appraisal case, but it is at least correlated to the size of the acquirer. While a large firm can buy a small firm, a small firm generally cannot—absent unusual circumstances—buy a large firm. As a result, mergers involving larger targets, on average, should involve larger acquirers. Our data confirm this. In a regression where our dependent variable was the log size of the target and the only independent variable was the log size of the acquirer, the coefficient on target size is positive and significant beyond the 1% level. Given this strong correlation, the use of target size cannot explain the lack of any significant relationship between deep pockets and the incidence of appraisal litigation.

C. *The Importance of the Merger Premium*

As has been noted, the only issue in an appraisal action is the fair value of the plaintiffs' shares, and the sole remedy is very straightforward—cash in exchange for the shares. Whatever its advantages or disadvantages to shareholders, this simplicity offers a comparatively clean opportunity to assess the merits of a claim.

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[245] The mean size of acquirers in the thirty-one transactions attracting an appraisal petition was $29.8 billion, while the mean acquirer size in the 579 transactions with no appraisal petition was $49.8 billion. The difference (in raw dollars or log dollars), as noted, is not statistically significant.

[246] *See, e.g.*, *In re* Trados Inc. S'holder Litig., 73 A.3d 17, 74 (Del. Ch. 2013) (noting that in appraisal, valuations must "back out any synergies"); Gearreald v. Just Care, Inc., No. 5233-VCP, 2012 WL 1569818, at *3 (Del. Ch. Apr. 30, 2012) ("Determining the value of a 'going concern' requires the [c]ourt to exclude any synergistic value . . . ."); Union Ill. 1995 Inv. Ltd. P'ship v. Union Fin. Grp., Ltd., 847 A.2d 340, 356 (Del. Ch. 2004) ("[T]his court must endeavor to exclude from any appraisal award the amount of any value that the selling company's shareholders would receive because a buyer intends to operate the subject company, not as a stand-alone going concern, but as a part of a larger enterprise, from which synergistic gains can be extracted.").

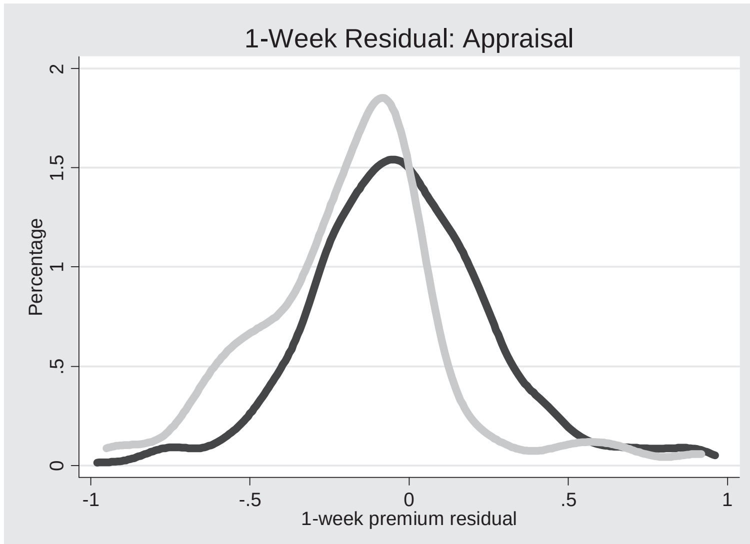
We rely on similar measures of residual deal premium to those described above in analyzing fiduciary duty class actions. The only difference here is that we use the residual from the *final* merger premium because this is the amount relevant to an appraisal petitioner who decides to file a petition only after the transaction has closed. We were able to determine these figures for eighty-nine deals that attracted appraisal actions—six *pro se* and eighty-three counseled—and 1,009 deals that did not. We find that for all three measures, the deals that attracted appraisal actions have lower residual premia, as shown in Table 5.

Table 5: *Comparison of Merger Premia Residuals in Appraisal Cases*

	1-Day Premium		1-Week Premium		4-Week Premium	
	Mean	Median	Mean	Median	Mean	Median
No Appraisal	2.2%	-3.2%	2.9%	-2.9%	2.9%	-2.9%
All Appraisal	-15.5	-16.1	-16.3	-13.2	-19.1	-20.7
Pro Se Appraisal	-9.5	-2.0	-11.9	0.3	-12.1	-3.0
Counseled Appraisal	-15.9	-16.2	-16.6	-14.5	-19.6	-21.3

The appraisal petitions target deals with highly negative residual premia residuals, and the differences between appraisal and non-appraisal transactions are all statistically significant beyond the 1% level in a two-sided t-test. Again, this demonstrates that appraisal petitioners target deals where the deal premium is significantly lower than would be expected based on the characteristics of the target company. Figure 4 below is a kernel density plot showing the likelihood of attracting counseled appraisal petitions by one-week residual premium, which illustrates the difference.

Figure 4: *Transaction Premia Residuals for Transactions with Counseled Appraisal (Gray), By One-Week Residual Premia*



The gray line shows the kernel density plot of the incidence of counseled appraisal petitions by residual transaction premium, while the black line shows the same for transactions not attracting counseled petitions. The plots for the one-day and four-week premia look substantially similar. The consistent pattern across the three measures is that appraisal litigation involves transactions with strongly negative residual premia.

As hypothesized, appraisal petitioners thus appear to target transactions with lower merger premia. While we lack an exogenous shock that would allow us to draw more firm causal inferences, the result certainly suggests that the appraisal petitions are brought with due regard to the merits.

D. *Empirical Analysis of the Determinants of Appraisal Proceedings*

As with fiduciary duty class actions, we use regression to examine more searchingly the determinants of appraisal proceedings. Our first approach is to construct logistic regression models, identifying the factors that predict whether or not a transaction will face an appraisal petition. In these models, our dependent variable is a dummy that takes the value of one if the transaction faced a counselled appraisal petition and zero otherwise. Our transaction dataset again includes ninety-four transactions that attracted at least one appraisal petition involving common stock, eighty-seven of which were counseled. We use the same independent variables as before: the log of transaction value, the residual premium, and variables for going private transactions and financial buyers.

Our results appear in Panel E in the Appendix. Under all specifications, our measures of deal premium residual are strongly significant, and the sign of the coefficient is always negative, meaning that appraisal petitioners are more likely to target deals with lower merger premia. In addition, the going private variable is positive and strongly significant in all specifications, suggesting appraisal petitioners target going private transactions, where conflicts of interest are most likely to be acute.

As we did with the fiduciary suits, we can estimate the effects of these variables on the incidence of appraisal litigation. A one standard deviation decrease in the one-week residual premium implies an increase of between 3.7% and 9.1% in the predicted probability of an appraisal petition. Similarly, a going-private transaction implies an increase in the likelihood of a petition between 2.1% and 14.0%.[247] All of the other variables—including, notably, transaction size—have no impact on the likelihood of an appraisal petition that is statistically distinguishable from zero.

[247] These numbers are in relation to a much smaller baseline incidence of appraisal litigation (only approximately 8%, versus 60% for fiduciary class action). *See supra* Part IV.

Our second empirical approach is again similar to our fiduciary duty analysis. Instead of treating appraisal as a binary yes-or-no question, we looked beyond the mere incidence of appraisal to see how many shares actually sought appraisal. Here we computed the percentage of equity value that sought appraisal in each transaction, rounding to the nearest percentage integer. Of the 1,168 appraisal eligible transactions, fifty-seven had 1% or more of shareholders seek appraisal.[248] We used these numbers as our dependent variables for a Poisson regression, using the same independent variables noted above.

The results of this regression appear in Panel F of the Appendix. As in our logistic regressions, the sign of the coefficient here for premium is negative under all specifications, and in each case it is statistically significant at the 1% level. Transaction size has a consistently positive sign but only equity size is significant and only under some specifications. Both the going-private dummy variable and the financial buyer dummy variable are significant in all specifications. In Model 2,[249] the marginal effect at the mean for a one standard deviation change in the log of equity size is an additional 0.03% of equity value seeking appraisal.[250] The estimated effect for a one standard deviation decrease

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[248] The firms in each transaction that sought appraisal are shown in the following table:

Percentage of Shareholders Seeking Appraisal, by Transactions	
Percentage of Shareholders Seeking Appraisal (Rounded to Nearest Integer)	Firms
0	1,111
1	20
2	6
3	7
4	4
5	6
6	2
7	1
8	3
9	1
11	1
12	1
15	1
17	1
19	1
21	1
31	1
Total	1,168

[249] We use Model 2 here instead of Model 3, as we do above, because in Model 2 equity value is statistically significant.

[250] The 95% confidence interval is 0.011% to 0.051%.

in the residual premium is much larger: 0.17%.[251] For going-private, the effect is even larger, an increase of 0.21% of equity value seeking appraisal; the effect for financial buyer is 0.13%.[252]

In sum, not only was an appraisal petition more likely to be filed the lower the residual premium, but the percentage of shares seeking appraisal also tended to go up as the residual premium decreased. By contrast, the incidence of appraisal was not predicted by the size of the transaction, and its intensity was only slightly related to size. Taken together, these results for appraisal litigation cast the corresponding results for fiduciary duty class actions—where deal size matters a great deal and merger premium matters little or not at all—in a particularly unflattering light.

VI. Implications for Corporate and Securities Litigation

Our results are strong evidence that the operation of fiduciary class actions is broken. While a full program of reform is well beyond the scope of this Article, we hazard here a few thoughts on the future of representative shareholder litigation. In short, we argue that altering the structure of shareholder litigation could help to ensure that it functions as a useful tool of corporate governance in the future.

A. *Limiting or Abolishing Shareholder Suits*

Given our findings that the merits matter little in traditional merger litigation, the most straightforward conclusion that could be drawn is that this type of merger litigation should be sharply limited or abolished altogether. Indeed, even without the compelling evidence we present as to lack of merit, the increasing frequency of fiduciary class actions challenging mergers of any significant size has already attracted harsh criticism. Robert M. Daines and Olga Koumrian, for example, have noted as follows: "The cost of these suits is pretty clear. Companies typically agree to pay plaintiffs' lawyer fees (about $1.2 million on average in the last two years) and must usually cover their own legal costs. What is less clear is how shareholders are benefiting from litigation."[253] They argue that some type of federal reform is necessary in order "to tame the recent upswing in deal litigation."[254]

Similarly, the U.S. Chamber of Commerce's Institute for Legal Reform has condemned merger class actions in categorical terms: "This is extortion through

[251] The 95% confidence interval is 0.14% and 0.20%.

[252] The 95% confidence interval is 0.13% to 0.31% for a going-private transaction and 0.07% to 0.18% for financial buyer.

[253] Robert M. Daines & Olga Koumrian, *Merger Lawsuits Yield High Costs and Questionable Benefits*, N.Y. Times DealBook (June 8, 2012, 10:38 AM), http://dealbook.nytimes.com/2012/06/08/merger-lawsuits-yield-high-costs-and-questionable-benefits/?_php=true&_type=blogs&_r=0, *archived at* http://perma.cc/RC6T-57Z3.

[254] *Id.*

litigation, plain and simple. Trial lawyers hold transactions hostage until they collect a 'litigation tax,' draining a share of the merger's economic benefit away from shareholders and into the lawyers' own pockets."[255] They too have called for substantial action at the federal level to curtail merger class actions.[256] Other commentators go even further. For instance, Stephen M. Bainbridge argues to the extent that shareholder litigation fails to deter wrongdoing—and its indifference to the merits makes it hard to imagine how it could provide much deterrence—there is no case to be made for its existence, and it ought to be abolished.[257]

While we agree that the failings of conventional shareholder litigation are quite plain, we believe that a blunderbuss approach to reforming shareholder suits (or eliminating them altogether) is actually unnecessary. At the same time as our results provide the most compelling evidence yet that shareholder litigation is largely unmoored from the merits, they also provide reason for optimism about the prospects for reform. In particular, our contrasting results for appraisal litigation demonstrate that the meritless nature of merger class actions stems from the particular features of shareholder litigation rather than from a more universal and unavoidable risk of nuisance litigation.

A number of structural features of fiduciary class actions potentially contribute to the problem. We consider the following five features to be the most problematic: (i) insurance policies that cover settlements but not damages following trial; (ii) the ability of plaintiffs' attorneys to secure fees in the absence of monetary recovery; (iii) disproportionate discovery costs faced by defendants; (iv) asymmetric litigation risk; and (v) the agency problem and lack of effective monitoring of plaintiffs' attorneys, which opens the door for litigation that is not in shareholders' interest. As we explain below, with appropriate reforms targeting these structural problems, the shareholder suit could be transformed into a potent tool for deterring misbehavior.

B. *Reforming Shareholder Suits*

Ironically, the structure of appraisal—a form of litigation that has long been derided as a misguided anachronism—may be a source of ideas for beneficial reform. Appraisal, in fact, supplies the central insight that guides our reforms:

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[255] ANDREW J. PINCUS, U.S. CHAMBER INST. FOR LEGAL REFORM, THE TRIAL LAWYERS' NEW MERGER TAX: CORPORATE MERGERS AND THE MEGA MILLION-DOLLAR LITIGATION TOLL ON OUR ECONOMY 1 (2012), *available at* http://www.instituteforlegalreform.com/uploads/sites/1/M_and_A.pdf.

[256] *Id.* at 10 ("Action is needed now to eliminate the abusive litigation that is hurting shareholders, and forcing corporations to spend millions of dollars on a litigation tax rather than on building their businesses, creating new jobs, and expanding our economy.").

[257] STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 404 (2002) (making a case for "eliminating derivative litigation"); *see also* BAKER & GRIFFITH, *supra* note 37, at 20 ("[I]f shareholder litigation does not deter, then it loses its core justification and ought, therefore, to be abolished.").

that the merits matter when controlled by plaintiffs with a genuine stake in the proceedings, who gain if the claims succeed and suffer if they fail. We outline the broad strokes of some reform ideas that emerge from this thinking.

Litigation activity is, of course, the product of a wide array of legal rules, establishing a complex framework of incentives. Reforms across various fields thus hold out the hope of improvement. For example, reforms to D&O insurance may be justified to limit the ability of insurers to cover settlement payments but not recovery at trial.[258] Arguably, such reforms should come from the insurance industry itself, but to the extent that the costs of meritless litigation constitute externalities, there is potentially a case for public regulation.

Similarly, additional scrutiny of fees awarded to plaintiffs' attorneys is appropriate to ensure some relationship between fees awarded and actual benefit to the plaintiffs. In the merger context, a strong presumption should exist that the only meaningful benefit to plaintiffs would be an increase in the merger consideration.[259] In particular, Delaware courts should be far more hesitant to approve an award of substantial attorneys' fees in a settlement providing only additional disclosure unless there is some reason to believe the additional disclosure has led to a higher price.[260] The courts might presume that the appropriate award of attorneys' fees in fiduciary class actions is some fixed percentage of the monetary benefit to the shareholders and nothing more. Reforms designed to reduce—or require sharing of—the costs of discovery could also be fruitful. Taken together, these reforms would radically reduce the incentive to mount a fiduciary challenge to transactions that do not merit challenge.

The focus of our proposed reforms, however, centers on two ideas: (i) that Delaware courts reverse course and privilege stockholders who acquire their stock *after* the announcement of a merger and (ii) that Delaware shift to an opt-in regime for merger claims.

Appraisal petitioners have large holdings that are often acquired after the announcement of the transaction for the purpose of pursuing the appraisal

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[258] *See generally* BAKER & GRIFFITH, *supra* note 37, at 128   51.

[259] *See supra* Part IV.D.

[260] Former Chancellor Strine recently emphasized the anomalous nature of awarding attorneys' fees for a disclosure-only settlement:

> [I]t's an odd thing about this job that you can award a lot of money to someone for a case and award money to an attorney when, in other contexts of the law—no medical malpractice plaintiff's lawyer walks out of cases with money in her pocket and turns on the client and says, "Well, remember, you've got that explanation about why the doctor made his choice in the operating room, and I know you feel a lot better. You don't have any money, but you know why the doctor made the choice he made with the scalpel, and I've got a couple hundred thousand dollars."

Transcript of Settlement Hearing and Application for Attorneys' Fees and Costs and the Court's Ruling at 30, *In re* Danvers Bankcorp, Inc. S'holders Litig., Consol. C.A. No. 6162-CS (Del. Ch. Oct. 19, 2011).

claim.[261] Plaintiffs in public-company merger claims, by contrast, do not. For purposes of bringing a fiduciary suit, the standing requirements pose severe limitations. To bring a derivative fiduciary claim in Delaware, Section 327 of the Delaware code requires that a plaintiff be an owner at the time of the alleged wrongdoing.[262] This requirement of contemporaneous ownership means that those who acquire stock after that time have no power to enforce the claims. One influential treatise summarizes the policy behind the rule as follows: "The purpose of section 327 is to eliminate abuses associated with derivative suits, and in particular to prevent the purchasing of shares in order to maintain a derivative action attacking a transaction that occurred prior to the purchase."[263]

Merger class actions are direct, not derivative, claims, but the contemporaneous ownership is also at work there too, albeit with a peculiar wrinkle. While the question of whether after-acquiring stockholders can be members of the class has never been squarely addressed, the Delaware courts have held that, due to uncertainty surrounding the question, stockholders who acquired stock only after the announcement of the transaction cannot serve as lead plaintiff.[264] As the Chancery Court has recognized, the basis of the fiduciary allegation is the board's agreement to unfavorable "terms of the merger, rather than the technicality of its consummation."[265] For this reason, the Chancery Court held in *Dieter v. Prime Computer, Inc.* that an after-acquiring stockholder was disqualified from serving as class representative.[266] The settled understanding seems to be that after-acquired investors are unwelcome in fiduciary class actions.[267]

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[261] For more on appraisal claims, see our companion paper, Korsmo & Myers, *supra* note 18 (manuscript at 19).

[262] DEL. CODE ANN. tit. 8, § 327 (2014) (requiring that a derivative stockholder allege that it held the stock "at the time of the transaction of which such stockholder complains").

[263] WELCH ET AL., *supra* note 263, § 327.3.

[264] *See* Dieter v. Prime Computer, Inc., 681 A.2d 1068, 1072–73 (Del. Ch. 1996).

[265] *In re* Beatrice Cos., Inc. Litig., 522 A.2d 865 (Del. 1987); *see also Dieter*, 681 A.2d at 1072 ("It is not the [m]erger that constitutes the wrongful act of which [p]laintiffs complain; it is the fixing of the terms of the transaction." (internal quotation marks omitted) (citation omitted))).

[266] *Dieter*, 681 A.2d at 1072–73.

[267] BALOTTI & FINKELSTEIN, *supra* note 140, § 13.25 (Supp. 2014) (citing Leighton v. Lewis, 577 A.2d 753 (Del. 1990)) ("[A] stockholder who purchases shares of stock after the announcement of the challenged merger should not be permitted to maintain a class action challenging the merger since he is not truly a member of the class."). Although precluded from service as lead plaintiff, after-acquiring stockholders are nevertheless often eligible to receive any benefits of the class action settlement because settlement classes are commonly defined to include transferees. *See In re* Prodigy Commc'ns Corp. S'holders Litig., No. Civ. A. 19113, 2002 WL 1767543, at *4 (Del. Ch. July 26, 2002) (citing *In re* Triarc Cos., Inc., Class and Derivative Litig., 791 A.2d 872, 878–79 (Del. Ch. 2001)) ("[W]hen a claim is asserted on behalf of a class of stockholders challenging the fairness of the terms of a proposed transaction under Delaware law, the class will ordinarily consist of those persons who held shares as of the date the transaction was announced and their transferees, successors and assigns."). Due to the extreme rarity of monetary recovery, however,

The policy behind the contemporaneous ownership requirement, however, gets things precisely backwards.[268] Our appraisal results are compelling evidence that one source of the dysfunction in fiduciary class actions is this limitation on who can bring claims. Stockholders who acquire their stock after the announcement of the merger can pursue appraisal claims,[269] and indeed they have considerable time to evaluate the merits of the appraisal claim before they must invest.[270] By contrast, the only investors who are in a position to enforce the board's fiduciary duties are those are those who happened to own target stock on the day of the merger announcement—and who presumably invested in the stock for reasons orthogonal to the enforcement of fiduciary duties. By freezing the universe of potential plaintiffs at the time of the transaction announcement, the contemporaneous ownership requirement keeps out new investors possessing expertise at identifying and prosecuting claims for breach of fiduciary duty. The scarcity of suitable lead plaintiffs is thus an artificial scarcity. To be sure, an existing investor could hire an expert attorney to help prosecute an action. But attorney control of the claims is often at the very root of the problems with shareholder litigation. An investor choosing to buy into a fiduciary claim should signal to the court and to the defendants that the investor believes the case to have merit and is willing to dedicate significant time and treasure into pursuing the claim.

The ironic result is that a policy purportedly instituted to avoid strike suits may, in fact, be blocking pursuit of meritorious claims while doing little to prevent strike suits. A beneficial reform to the procedures used to select lead counsel in Delaware, therefore, would be to give priority to investors by the amount of stock they acquire after the announcement of the merger.[271]

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inclusion in the recovery class without an ability to influence the litigation is of limited practical utility.

[268] We are neither the first commentators nor the most influential to criticize the contemporaneous ownership requirement. *See, e.g.*, J. Travis Laster, *Goodbye to the Contemporaneous Ownership Requirement*, 33 DEL. J. CORP. L. 673, 673 (2008) (arguing that the rule is "fundamentally incoherent," that it "operates largely at random," and that "it arbitrarily mandates the dismissal of potentially meritorious claims"); Macey & Miller, *supra* note 41, at 77 ("The rationale for the contemporaneous ownership rule . . . appears questionable at best.").

[269] In another paper, we present evidence that this phenomenon is becoming increasingly common in appraisal, leading to the rise of what we call "appraisal arbitrage." *See* Korsmo & Myers, *supra* note 18 (manuscript at 1).

[270] In a tender offer, an investor can acquire appraisal rights by purchasing right up until the expiration of the offer. In a transaction where shareholders will vote, stockholders who invest before the vote can seek appraisal. *See In re* Transkaryotic Therapies, Inc., 954 A.2d 346, 368 (Del. Ch. 2008) (holding that the record date is not the cutoff for standing to seek appraisal).

[271] Unlike the federal PSLRA standard, Delaware does not adhere to a strict ranking by value of holdings in selecting a leadership structure. *See In re* Revlon, Inc. S'holders Litig., 990 A.2d 940, 955 (Del. Ch. 2010) ("[T]he weight given to the size of a plaintiffs' holding is not used to generate a formalistic ranking, but rather comes into play when a plaintiff owns a

If the only reform Delaware were to undertake is to abandon the contemporaneous ownership requirement, investors might acquire stock not to pursue meritorious fiduciary claims but to win the prize position of speaking on behalf of a large shareholder class. They could then exploit that class to spread litigation costs and extort an *in terrorem* settlement. Additional reforms, however, could help ensure that investors refrain from bringing actions that shareholders do not want and settling them on terms they would not approve. Again appraisal can serve as a model. Appraisal petitioners must opt-in to the claim by taking several steps to preserve their appraisal rights. The only aggregation of claims in appraisal is via a would-be petitioner accumulating additional shares or by multiple petitioners affirmatively opting in.

Drawing on the appraisal example, fiduciary litigation might abandon the class action model and insist that claims can be prosecuted only on behalf of those who affirmatively seek to prosecute them. As a result, no shareholder would have the ability to hold up a transaction with the threat of a catastrophic class action. The downside of this reform, of course, is that it would effectively strip many small stockholders of their ability to pursue fiduciary claims. This downside, however, is more symbolic than real. As things currently stand, there is little evidence to suggest that minority shareholders—indeed, any shareholders—obtain any material benefits from the operation of merger class actions. Thus, switching to an opt-in regime would not strip minority shareholders of anything they do not already lack. On the contrary, any loss would be more than offset by the benefits associated with an enforcement regime that had some genuine deterrent power.

By privileging after-acquired shares and moving to an opt-in regime, the fiduciary enforcement regime would allow arbitrageurs to purchase shares following a merger announcement with the intention of prosecuting a claim. By amassing a large position, these arbitrageurs could solve the collective action problems that would otherwise plague shareholder litigation without creating an agency problem in their stead. And they would have no power to bring nuisance claims based on nothing more than the size of the shareholder class. We would expect reforms along these lines to lead to a dramatic redeployment of litigation resources. Under the current rules, almost every transaction attracts a small volley of claims, but none proceed to trial. We predict that our rules would result in far fewer transactions facing any fiduciary litigation, while those that do attract claims would involve more intense litigation activity, including more trials. These proposals raise a host of complex practical and policy issues that are beyond the scope of this Article, but the present woeful state of merger litigation warrants consideration of such ambitious reforms.

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sufficient stake to provide an economic incentive to monitor counsel and play a meaningful role in conducting the case.”).

VII. CONCLUSION

This Article presents new and compelling evidence to supply an answer to one of the most fundamental and long-running debates in corporate and securities law: Do the merits matter in shareholder litigation? For decades, resolution of this debate has been hampered by the difficulty of defining and assessing the "merits" of shareholder claims. We provide a novel solution to this problem by exploiting the differences between the two types of legal claims available to shareholders who object to a merger—a state-law fiduciary duty class action and a shareholder appraisal action seeking judicial valuation of their shares. Both types of claims seek to remedy the same wrong—a merger price that is too low—but appraisal claims are structured such that they are unlikely to share the pathologies of other forms of shareholder litigation.

Our results reveal that in fiduciary duty class actions targeting mergers, the decision to bring a claim is driven largely by the pursuit of deep pockets, with only slight regard for the adequacy of the merger price. By contrast, in a corresponding sample of appraisal actions, we find that petitioners target mergers with unusually low merger prices, rather than simply targeting large deals. In addition to providing the strongest evidence yet that the merits do not matter in most shareholder litigation, our findings imply that many of the well-known pathologies of shareholder litigation are driven by the structure of the class and the resulting agency problems. We argue that these results suggest that the appraisal remedy—routinely dismissed by most corporate law scholars—could serve as a model to reduce meritless claims in representative shareholder litigation.

APPENDIX

Panel A: *Logistic Regression: Dependent Variable Is the Filing of a Fiduciary Class Action*

VARIABLES		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Size	Equity value (log)	0.339***	0.366***	0.372***	0.374***				
		(0.0380)	(0.0391)	(0.0396)	(0.0394)				
	Enterprise value (log)					0.307***	0.318***	0.323***	0.327***
						(0.0370)	(0.0377)	(0.0382)	(0.0380)
Premium residuals	1-day	-0.469**	-0.417**			-0.441**	-0.390**		
		(0.1860)	(0.1860)			(0.1820)	(0.1820)		
	1-week			-0.401**				-0.386**	
				(0.1840)				(0.1800)	
	4-week				-0.403**				-0.370**
					(0.1720)				(0.1690)
Going private			0.0762	0.0837	0.0667		0.0364	0.0409	0.0292
			(0.2120)	(0.2130)	(0.2130)		(0.2110)	(0.2110)	(0.2110)
Financial buyer			0.899***	0.912***	0.890***		0.822***	0.835***	0.813***
			(0.1700)	(0.1710)	(0.1700)		(0.1670)	(0.1680)	(0.1670)
Constant		-1.633***	-2.024***	-2.073***	-2.075***	-1.469***	-1.746***	-1.789***	-1.799***
		(0.2350)	(0.2510)	(0.2550)	(0.2530)	(0.2330)	(0.2450)	(0.2480)	(0.2460)
Observations		1,092	1,092	1,088	1,096	1,084	1,084	1,080	1,088
Pseudo R-squared		0.063	0.088	0.090	0.090	0.054	0.075	0.076	0.077

*** p<0.01, ** p<0.05, * p<0.1

Panel B: *Logistic Regression: Dependent Variable Is the Filing of Six or More Fiduciary Class Actions*

VARIABLES		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Size	Equity value (log)	0.477***	0.486***	0.494***	0.484***				
		(0.0650)	(0.0649)	(0.0662)	(0.0653)				
	Enterprise value (log)					0.424***	0.427***	0.435***	0.425***
						(0.0601)	(0.0600)	(0.0613)	(0.0602)
Premium residuals	1-day	-0.5	-0.399			-0.456	-0.343		
		(0.3840)	(0.3850)			(0.3690)	(0.3640)		
	1-week			-0.548				-0.496	
				(0.3880)				(0.3680)	
	4-week				-0.255				-0.215
					(0.3370)				(0.3150)
Going private			0.523*	0.524*	0.525*		0.471*	0.469*	0.474*
			(0.2710)	(0.2710)	(0.2710)		(0.2700)	(0.2700)	(0.2700)
Financial buyer			0.498**	0.506**	0.496**		0.455**	0.465**	0.454**
			(0.2240)	(0.2240)	(0.2250)		(0.2230)	(0.2230)	(0.2240)
Constant		-5.239***	-5.537***	-5.601***	-5.519***	-4.915***	-5.156***	-5.221***	-5.143***
		(0.4730)	(0.4840)	(0.4940)	(0.4840)	(0.4440)	(0.4540)	(0.4640)	(0.4530)
Observations		1,092	1,092	1,088	1,096	1,084	1,084	1,080	1,088
Pseudo R-squared		0.085	0.101	0.102	0.101	0.075	0.089	0.089	0.089

*** p<0.01, ** p<0.05, * p<0.1

Panel C: *Poisson Regression: Dependent Variable Is the Number of Fiduciary Suits Against a Transaction*

VARIABLES		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Size	Equity value (log)	0.299***	0.301***	0.301***	0.304***				
		(0.0123)	(0.0121)	(0.0122)	(0.0123)				
	Enterprise value (log)					0.270***	0.269***	0.270***	0.272***
						(0.0116)	(0.0115)	(0.0116)	(0.0117)
Premium residuals	1-day	-0.432***	-0.363***			-0.409***	-0.332***		
		(0.0767)	(0.0764)			(0.0749)	(0.0740)		
	1-week			-0.335***				-0.316***	
				(0.0742)				(0.0718)	
	4-week				-0.304***				-0.271***
					(0.0686)				(0.0659)
Going private			0.347***	0.350***	0.345***		0.320***	0.322***	0.320***
			(0.0544)	(0.0544)	(0.0545)		(0.0546)	(0.0546)	(0.0547)
Financial buyer			0.329***	0.333***	0.323***		0.307***	0.312***	0.301***
			(0.0457)	(0.0458)	(0.0459)		(0.0458)	(0.0459)	(0.0460)
Constant		-1.176***	-1.348***	-1.350***	-1.366***	-1.010***	-1.154***	-1.161***	-1.169***
		(0.0889)	(0.0894)	(0.0901)	(0.0902)	(0.0853)	(0.0862)	(0.0870)	(0.0869)
Observations		1,092	1,092	1,088	1,096	1,084	1,084	1,080	1,088
Pseudo R-squared		0.107	0.129	0.128	0.129	0.096	0.115	0.114	0.115

*** $p<0.01$, ** $p<0.05$, * $p<0.1$

Panel D: *OLS Regression: Dependent Variable Is the Increase in Merger Consideration After Announcement*

VARIABLES		(1)	(2)	(3)	(4)	(5)	(6)
Size	Equity value (log)		-0.00198		-0.00249		-0.00328
			(0.00228)		(0.00239)		(0.00244)
	Enterprise value (log)	-0.00171		-0.00210		-0.00283	
		(0.00226)		(0.00234)		(0.00240)	
Premium residual: 1-day		-0.0160*	-0.0155*	-0.0156*	-0.0150	-0.0154*	-0.0149
		(0.00935)	(0.00924)	(0.00938)	(0.00927)	(0.00936)	(0.00925)
Going private		0.0528***	0.0521***	0.0528***	0.0520***	0.0509***	0.0499***
		(0.0131)	(0.0130)	(0.0131)	(0.0130)	(0.0132)	(0.0131)
Financial buyer		-0.0210**	-0.0212**	-0.0219**	-0.0225**	-0.0223**	-0.0228**
		(0.0102)	(0.0102)	(0.0103)	(0.0103)	(0.0102)	(0.0102)
Fiduciary case (dummy)				0.00557	0.00662		
				(0.00909)	(0.00910)		
Number of fiduciary suits						0.00196	0.00211
						(0.00141)	(0.00141)
Constant		1.033***	1.034***	1.032***	1.034***	1.036***	1.038***
		(0.0150)	(0.0150)	(0.0151)	(0.0150)	(0.0152)	(0.0152)
Observations		1,083	1,091	1,083	1,091	1,083	1,091
R-squared		0.019	0.019	0.020	0.020	0.021	0.021

*** p<0.01, ** p<0.05, * p<0.1

Panel E: *Logistic Regression: Dependent Variable Is the Filing of a Counseled Appraisal Petition*

VARIABLES		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Size	Equity value (log)	0.0544	0.0893	0.0966	0.117				
		(0.0705)	(0.0701)	(0.0711)	(0.0723)				
	Enterprise value (log)					0.0400	0.0549	0.0648	0.0825
						(0.0687)	(0.0681)	(0.0690)	(0.0696)
Premium residuals	1-day	-1.706***	-1.734***			-1.781***	-1.759***		
		(0.437)	(0.444)			(0.441)	(0.444)		
	1-week			-1.738***				-1.757***	
				(0.436)				(0.435)	
	4-week				-1.711***				-1.715***
					(0.412)				(0.407)
Going private			0.990***	1.003***	0.959***		0.993***	1.008***	0.964***
			(0.290)	(0.292)	(0.292)		(0.289)	(0.292)	(0.291)
Financial buyer			0.244	0.234	0.183		0.232	0.220	0.167
			(0.265)	(0.267)	(0.268)		(0.265)	(0.267)	(0.268)
Constant		-2.971***	-3.467***	-3.515***	-3.644***	-2.884***	-3.249***	-3.314***	-3.427***
		(0.470)	(0.490)	(0.497)	(0.507)	(0.464)	(0.474)	(0.482)	(0.486)
Observations		1,098	1,098	1,094	1,102	1,090	1,090	1,086	1,094
Pseudo R-squared		0.033	0.061	0.062	0.065	0.035	0.063	0.064	0.067

*** $p<0.01$, ** $p<0.05$, * $p<0.1$

Panel F: *Poisson Regression: Dependent Variable Is the Integer Percentage of Equity Value Dissenting in Appraisal*

VARIABLES		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Size	Equity value (log)	0.0453	0.114***	0.0733*	0.108***				
		(0.0388)	(0.0389)	(0.0382)	(0.0392)				
	Enterprise value (log)					0.0312	0.0355	0.0179	0.0457
						(0.0373)	(0.0368)	(0.0363)	(0.0367)
Premium residuals	1-day	-2.591***	-2.482***			-2.768***	-2.340***		
		(0.217)	(0.219)			(0.209)	(0.190)		
	1-week			-2.042***				-1.991***	
				(0.210)				(0.188)	
	4-week				-2.111***				-2.020***
					(0.205)				(0.180)
Going private			1.020***	1.032***	0.982***		0.983***	1.025***	0.976***
			(0.142)	(0.143)	(0.141)		(0.140)	(0.141)	(0.140)
Financial buyer			0.726***	0.715***	0.660***		0.711***	0.703***	0.645***
			(0.137)	(0.139)	(0.139)		(0.137)	(0.139)	(0.139)
Constant		-2.024***	-2.959***	-2.634***	-2.879***	-1.964***	-2.445***	-2.281***	-2.477***
		(0.264)	(0.284)	(0.274)	(0.284)	(0.255)	(0.256)	(0.252)	(0.257)
Observations		1,098	1,098	1,094	1,102	1,090	1,090	1,086	1,094
Pseudo R-squared		0.089	0.151	0.132	0.139	0.097	0.155	0.138	0.144

*** $p<0.01$, ** $p<0.05$, * $p<0.1$